Can a united Europe end Russia's energy stranglehold?

An assessment of the potential for European Union countervailing power in EU-Russian gas trade

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A special thanks to my parents is in order, as they have helped me to cross the finish line by virtue of their patience, knowledge and kindness.

Summary

In this thesis I analyze the degree to which a coordination of EU gas purchases under an EU single buyer structure will allow the EU to countervail Russia's market power within the EU gas market – as proposed by Donald Tusk (the Polish proposal). The background for this choice of research subject it at the one hand the rising import dependency of the EU and at the other hand the increasingly assertive Russian foreign policy, which combined has resulted in concerns for the EU's security of supply. In particular, it is claimed that the Russian state owned gas company Gazprom is abusing its position as a monopoly or dominant supplier to Central and Eastern European Member States by imposing unfair prices and non-commercial clauses in the supply contracts signed with these national markets. The Polish proposal is the most comprehensive and detailed proposed solution to the EU energy supply question to come forth so far. Although the single buyer mechanism – one of six 'pillars' of the Polish proposal – was not included in the European Commission's *Energy Union* framework published this spring, it is nonetheless of analytical value to assess the *logic* applied by Tusk in this specific pillar, as it provides us with improved understanding of what problems the EU is currently facing what regards its security of (Russian gas) supply. In this thesis, I set the scene for my analysis by delving into the organization and functioning of the EU gas market, as well as the historical origin of EU-Russian gas trade. I argue that the problem currently facing the EU is one of Russian market power - or rather, one of lack of EU buyer power. The problem is also of a political nature as the EU's energy acquis now extends so far east that it applies in areas where Russia has monopoly ownership over the gas grid, and as such, creates a regulatory overlap.

I have used the conceptual framework of countervailing power, as provided by Galbraith (1952) to analyze the problem solving potential of the Polish proposal. As the concept of countervailing power – to balance out an existing powerful market player by establishing an equally powerful market player at the opposite side of the market – is not universally accepted, I have supported my analysis on more contemporary literature on buyer power. This literature supports Galbraith's argumentation. Two prerequisites must be present for countervailing power to deliver the desired result; 1) the ability of buyers (in this case) to organize behind a common position vis-à-vis a dominant seller, and 2) the ability to create

for the seller a scarcity of demand through own market behavior, e.g. withholding demand or switching to another supplier (outside options). I have analyzed the EU's buyer power under two scenarios according to the prerequisites for countervailing power identified by Galbraith; the current unorganized buyer structure and the single buyer structure. I have focused on the buyer power of the Baltic market (Estonia, Latvia and Finland) as a test for the validity of Tusk's claim (that acting as a single buyer will allow the EU to countervail Russia's market power) because the Member States constituting this market represents the most extreme example of EU buyers without buyer power. It suffices to analyze the effect of the Polish proposal on Russia's market power in this market, as the EU as a whole is only as strong as its weakest Member State. I have discarded the countervailing power potential of the Polish proposal on the grounds that it does not reduce Russia's market power in the Baltic market. The Polish proposal should nonetheless not be discarded completely, as its implementation could enhance the overall compliance with the EU energy acquis, facilitate for improved coordination and information gathering, as well as enhanced market monitoring. Based on my analysis, the EU should focus on improving the interconnection between the fragmented markets, as this would enhance the buyer power of the Union as a whole.

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Abbrevations

Mtoe: Million tonnes of oil equivalent

GIC: Gross Inland Consumption of energy (all sources)

GICG: Gross Inland Consumption of natural gas

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Chapter 1: Introduction

In a Financial Times article published last spring, then prime minister of Poland, Donald Tusk, revived the idea of creating an Energy Union for the European Union (EU) (Tusk, 2014a). The background for this article was Tusk's non-paper *Roadmap towards an Energy Union for Europe,* which he submitted to the Commission in April last year, two weeks prior of the above mentioned Financial Times article (Polish government, 2014). In this non-paper, Tusk argued that the EU should create an Energy Union to increase the energy security of the EU, and spelled out six pillars upon which such an Energy Union should be built – each addressing a specific dimension of the EU's energy security. One of the pillars of what has become known as the *Polish proposal* has been deemed extremely controversial and been subjected to much criticism; the idea of coordinating all gas purchases under a supranational Gas Supply Agency so as to allow the EU to buy gas as a single buyer. According to Tusk, the EU should act as a single buyer when purchasing gas, as this would allow the EU to countervail Russia's market power at the EU gas market – a power that Tusk has referred to as an 'energy stranglehold' (Tusk, 2014a). In this thesis, I will assess the validity of this claim.

While the idea of an Energy Union is as old as the EU itself, there is something special about the ideational relaunch provided by Tusk. First, it reflects a perception of energy security that is particular for the newest member of the Union. As Piotr Serafin, Tusk's European Affairs Minister at the time, has argued, the proposal was meant to be "the voice of Central and Eastern Europe on security of supply" (Beckman, 2015). Where Western European EU members are known to regard energy security as a matter of economics, Eastern and Central European members regard it as a matter of security policy (Esakova, 2012, p. 44). As most of these newest members are, for historical reasons, completely dependent on Russian gas imports and subjected to extensive Russian market power – a stark contrast to the diversified supply portfolios and strong bargaining power of the Western members – energy politics amounts to so much more than the conventional definition of security of supply

(adequate supplies at affordable prices); its also a matter of resisting the political influence that arises out of dependence on Russia. This consideration has yet to be properly addressed at the Union level, although it was mentioned in the Commission's Energy Union Package, published this spring:

> "Energy policy is often used as a foreign policy tool, in particular in major energy producing and transit countries. This reality has to be taken into account when discussing Europe's external energy policy" (European Commission, 2015a, p. 6).

Second, Tusk's timing could hardly have been better. The non-paper was submitted to the Commission less than a month after the Russian invasion of Crimea and aggression in Ukraine, a vital transit country for Russian gas imports to Central and Eastern Europe. Russia's aggression in Ukraine has served to reinforce Russia's poor reputation arising out of the Russian-Ukrainian gas disputes of 2006 and 2009 as well as a line of allegations against Russia in which it is claimed that the country has abused its market power at the EU gas market. Many now share the opinion of Tusk; "…Russia is not our strategic partner. Russia is our strategic problem" (Foy, 2014). The timing was right also what regards the political climate within the EU institutions. With the election of Jean-Claude Junker – an outspoken proponent of an energy union - as president of the Commission on the 15th of July last year, impetus was given to the project from within the Commission. This impetus was particularly visible in the appointment of a wholly new Commissioner position; the vice-president of the Energy Union. The Energy Union is one of Junkers top-ten priorities for his term in office. Speaking ahead of the vote, Junker argued that

> "Current geopolitical events have forcefully reminded us that Europe relies too heavily on fuel and gas imports. I therefore want to reform and reorganize Europe's energy policy into a **new European Energy Union**. We need to pool our resources, combine our infrastructures and unite our negotiation power vis-à-vis third countries" (Junker, 2014, p. 5).

On the 30th of August last year, Tusk was elected president of the European Council. As it is this Council in cooperation with the Commission that sets the general political direction for the EU, the scene seems to be set for a very real effort towards the establishment of an energy union. While the Commission did not include the single buyer proposal in its Energy

Union Package published this spring – also arguing for the creation of an energy union- it is nonetheless interesting to assess the potential of the Polish proposal to mitigate Russian market power at the EU gas market as it provides a great backdrop for exploring what obstacles are currently facing the EU in terms of ensuring the Member States' security of supply.

The reason why Russia's invasion of Crimea provided such a pungent backdrop for the Energy Union debate is due to the increasing import dependency of the EU what regards natural gas. As Russia is the number one supplier of natural gas to the Union, the increasingly assertive foreign policy of Russia and its historical monopoly over pipelines and supply in Eastern and Central Europe is particularly a cause for concern. Russia's market power at the EU gas market has proven incredibly resilient against EU efforts at liberalization and regulation, and the country has repeatedly been accused of abusing its dominant market position in the most dependent national 'sub-markets'. When Tusk announced his proposal to the public in the above mentioned Financial Times article, this problem of market power was presented as the main justification for an energy union:

> "…excessive dependence on Russian energy makes Europe weak. And Russia does not sell its resources cheap – at least, not to everyone" (Tusk, 2014a).

1.1 **Research Subject**

The focus of this thesis is the third pillar of the so-called *Polish Proposal,* in which Tusk proposes a strategy for the EU to "Strengthen the bargaining power of Member States and the EU vis-à-vis external suppliers" (Polish government, 2014). Under this pillar Tusk spells out a method for how the compliance of both commercial and intergovernmental supply contracts with the EU energy acquis could be enhanced. I will focus on the part of this proposal regarding commercial contracts, that is, supply contracts signed between external suppliers and EU gas undertakings (companies). For ensuring the compliance of such contracts with the energy acquis, Tusk proposes a coordination mechanism similar to that performed by the Euratom Supply Agency; a supranational Agency which purchases nuclear materials for the EU as a block – that is, as a *single buyer*. Tusk argues that the EU should take the same approach towards gas supplies (Tusk, 2014a). The background for the need to enhance the bargaining power of the EU and its Member States is what Tusk refers to as the

Russian 'energy stranglehold'. According to Tusk, Russia has been leveraging its monopoly position as sole supplier to the easternmost part of the EU gas market to extract more-than-competitive concessions from those that have no outside option to Russian gas – hence the 'stranglehold' analogy. Such market behavior is contrary to EU competition law and hampers the overall competition in the market. The accusations raised by Tusk are shared by the Commission, which has opened an antitrust case against the Russian company Gazprom, the only Russian gas company operating at the EU gas market (European Commission, 2012). Tusk argue that the problem with Russia's market power is self-sustaining, because the member states who are subjected to it are also those that, by virtue of being completely dependent on Russian gas, virtually lack any buyer power vis-à-vis their dominant supplier. As such, their hands are tied. This lack of buyer power, argues Tusk, is not endemic to the European Union as a whole; especially not to the member states that constitutes Russia's largest European export markets, in particular Germany and Italy. The main assumption and crux of the proposed coordination mechanism is that the EU, when united, is capable of aggregating more buyer power than Russia, and that the Union should take advantage of this and stand together so as to effectively *deny* Russia its ability to exercise market power in the most vulnerable states;

> "A dominant supplier has the power to raise prices and reduce supply. The way to correct this market distortion is simple. Europe should confront Russia's monopolistic position with a single European body charged with buying its gas" (Tusk, 2014a).

1.2 **Research question**

In this thesis, I will elaborate on the coordination mechanism proposed in the Polish proposal and analyze its potential to mitigate the problem of Russia's market power. I will contrast the EU's buyer power under the scenario spelled out in this proposal with the EU's buyer power under the current uncoordinated buyer structure. My analysis will be guided by the following research question; *will the establishment of an EU single gas buyer allow the EU to countervail Russia's market power*?

1.3 **Background for choice of research subject**

The background for this choice of subject is the observation that there is an obvious shortage in the ongoing energy union debate: the failure to acknowledge that attempts at

making functional the common market for gas are futile so long as this market lack a coherent external boundary vis-à-vis external suppliers. Just as the single market for goods would have been unthinkable had it not been for the customs union, the establishment of a common gas market devoid of coherent conditions for entry seems rather contradictory. That the one is pursued without the other is a paradox, and nowhere is this more evident than in the Union's relationship with Russia. While the EU is constantly requiring that Russia treat all Union members (with whom it trades) on equal terms – that is, on best available terms *as if the market was complete* – the Union itself cannot project any sort of unified energy policy outwards. So long as the EU does not act as a bloc, it can hardly require from its suppliers to be treated as one. Russia, of course, refuses to comply. This paradox is the foundation for the Commission's repeated claim that "speaking with one voice" is the key to securing the Unions energy interests abroad (European Commission, 2011).

1.4 **Conceptual framework and methodology**

The idea that it is possible to mitigate the effects of existing market power at one side of a market by establishing a competing market power at the other side of said market, has been conceptualized by John K. Galbraith as *countervailing* power (Galbraith, 1952). This framework will guide my analysis. According to Galbraith, the successful projection of countervailing power rests upon two conditions; (1) the parties subjected to market power must have a minimum opportunity for, and organizational capacity to, coordinate their actions behind a single position; and (2) when united behind such a position, the parties subjected to market power must be able to credibly threaten to, through a change in own market behavior, inflict a state of not unlimited demand upon the supplier (Galbraith, 1993, p. 126 and 131). As the possibility to fulfill this latter condition is determined by the relationship between supply and demand on the specific market, it amounts to a question of relative market power between buyer and seller. As Galbraith's framework is abstract, not going into the details on the mechanisms underpinning such buyer power, I will support my analysis with results from recent academic insight on the topic.

1.5 **Out of scope**

1.5.1. Supply disruptions

Part of the concerns with the Union's import dependency is that of the possibility that Russia, by virtue of controlling both transmission and distribution infrastructure, can cut off supply flows to the EU market. I will not deal with this aspect of security of supply in this thesis. I base my analysis upon the assumption that there is a mutual interest for both the EU and Russia in sustaining the current gas trade.

1.5.2. The uncertain validity of the Commissions allegations against Russia

Price differences across national markets can have several origins, including the taxation levels and market policies of the various member states. The issue of domestic causes for price differences will not be dealt with here. For the purpose of this thesis, I will assume that the allegations raised by the Commission in its antitrust case against Gazprom are true. There exist, however, uncertainties as to whether or not this is the case, as the proceedings are not yet completed. The Commission has requested insights into the various supply contracts that are under investigation, which has yet to be accepted by Russia.

1.5.3. The Energy Community

I will limit my analysis to the part of the gas market that falls within the boundaries of the EU proper. While the Energy Community Treaty extends the current energy acquis, including the competition rules and the third energy package, into Albania, Bosnia, Herzegovina, Kosovo, FYR Macedonia, Moldova, Montenegro, Serbia and Ukraine, it is uncertain whether an EU single buyer could be extended also to these non-EU members, and they will therefore be disregarded in my discussion.

1.5.4. Outside options in the long term

While several alternative sources for supply and demand exist for the EU and Russia in the long term, I will focus on the opportunities for trade within the current market infrastructure. As such, the possibility that Russia might divert some of its European gas export to the Chinese market will be disregarded, as will the EU's potential gas imports from the Caspian basin.

1.6 **Definitions**

1.6.1. Security of supply

Security of (gas) supply refers to the continuous supply of *adequate* and *affordable* quantities of gas to the market at all times (Mitchell, 2009, p. 2). The term is part of the overall concept of energy security, which previously referred only to considerations of security of supply, but now also includes considerations of environmental sustainability and international competitiveness (Cherp and Jewell, 2014, p. 416).

1.6.2 EU energy acquis

The EU's energy acquis is a term used when referring to the "core EU energy legislation in the area of electricity, gas, environment, competition, renewables, energy efficiency, oil and statistics" (Energy Community). When used in this thesis, I refer to the part of this energy legislation that applies to the EU gas market.

1.6.3 Market power and countervailing power

Market power, by definition, refers to the ability of a purchaser/seller to *profitably* offer/charge a lower/higher price than the market price – often referred to as buyer or seller power respectively (Bernheim and Whinston, 2008, p. 623). The emphasis is on 'profitable' because any such offer/charge would result in a total loss of market share under competitive market conditions – that is, in a market where no one has any market power. While the price in question traditionally refers to actual price, market power can also be used to extract political concessions or any other concession on more favorable terms than what would have been possible in a competitive market (Chen, 2007, p. 19).

Countervailing power refers to market power that develops at either side of the market *in response* to the existence of market power at the opposite side of the market (the 'original' market power). A buyer/seller has countervailing power if he can profitably force the original market power to agree upon more competitive terms.

A market in which there exists a player with market power at both sides of the market is often called dual monopoly. I refrain from using this term here, as the conceptual framework offered by Galbraith allow us to focus on *why* countervailing power is established – that is,

to restore more competitive market conditions – as opposed to the term 'dual monopoly' which brings associations to a wholly uncompetitive market.

1.6.4 Infrastructure and interconnectedness

The term 'infrastructure' is used in this thesis to signify existing pipelines used for import/export, while 'interconnectedness' refers to the *internal* EU gas grid, that is, pipelines that connect various national markets with one another. While the two need not be mutually exclusive, I distinguish between them in this thesis to make clear what part of the EU gas market I am referring to.

1.7 **Structure of the thesis**

In order to understand the mechanisms that underpins the Russian energy stranglehold, it is necessary to have basic insights into the specifics of the EU gas market, the nature of gas trade, and the origin of Russia's market power. In chapter two I start off by delving into the issue of the EU's rising import dependency on foreign gas. This section will be followed by a presentation of the current structure of the EU gas market, including the structure of gas supplies. Special attention will be given to how the nature of gas trade is inherently noncompetitive as well as the legislation that has been adopted by the EU in order to overcome this challenge. Chapter three is devoted to the historical origin of the EU-Russian gas trade, as the current problem of Russia's market power has roots in a specific historical context. In chapter four the content of the so-called energy stranglehold is presented. This presentation will be based on the allegations upon which the Commission is currently pursuing its antitrust case against Gazprom, the only Russian company operating within the EU. The Polish proposal is presented in chapter five, and an introduction to Galbraith's conceptual framework follows in chapter six. In chapter seven I analyze the potential of the Polish proposal to mitigate Russia's market power. I conclude on my findings in chapter eight.

Chapter 2: The EU gas market - an introduction

In this chapter I offer an introductory overview on the current state of the EU's gas demand, import dependency, and the organization of the EU gas market.

2.1 The rising import dependency of the EU

Natural gas has made quite an entrance on the European energy market over the past two decades. Since 1990, the EU-28 gross inland consumption of natural gas (GICG) has increased by more than 20 percent (European Commission, 2014b, p. 44). As indigenous production is insufficient to cover demand, the Union is dependent on foreign supplies, and more than 65 percent of domestic consumption originated from extra-EU sources in 2012 (European Commission, 2014b, p. 24). This share is expected to continue to rise on the account of three developments.

First, by virtue of having a relatively lower emission profile compared to that of oil and coal, the demand for natural gas is predicted to rise in accordance with the EU's increasingly ambitious goals for reducing the Union's emission of greenhouse gasses. As the Union transitions towards a low-carbon economy – a stated goal in the Union's 2020 climate and energy package, as well as in the newly adopted 2030 framework agreement for climate and energy policies - the share of coal and oil in the energy mix must necessarily be reduced – natural gas or renewables being the obvious substitutes (European Commission 2014c and 2015).

As the use of renewables to a large degree depends on government subsidies due to the infant status of the sector, gas will often serve as a bridge fuel for a certain initial period. The transition towards a low carbon economy and its impact on the EU energy mix is already apparent in the fact that natural gas is the only conventional fuel which consumption has *increased* in the EU energy mix since 1990, as have renewables (se figure 1). For all other fuels (oil, coal, and nuclear) the numbers have declined. As the goal of the above mentioned 2030 framework agreement is a minimum reduction in domestic emission of greenhouse gasses of 40 percent compared to the levels in 1990, this trend will continue.

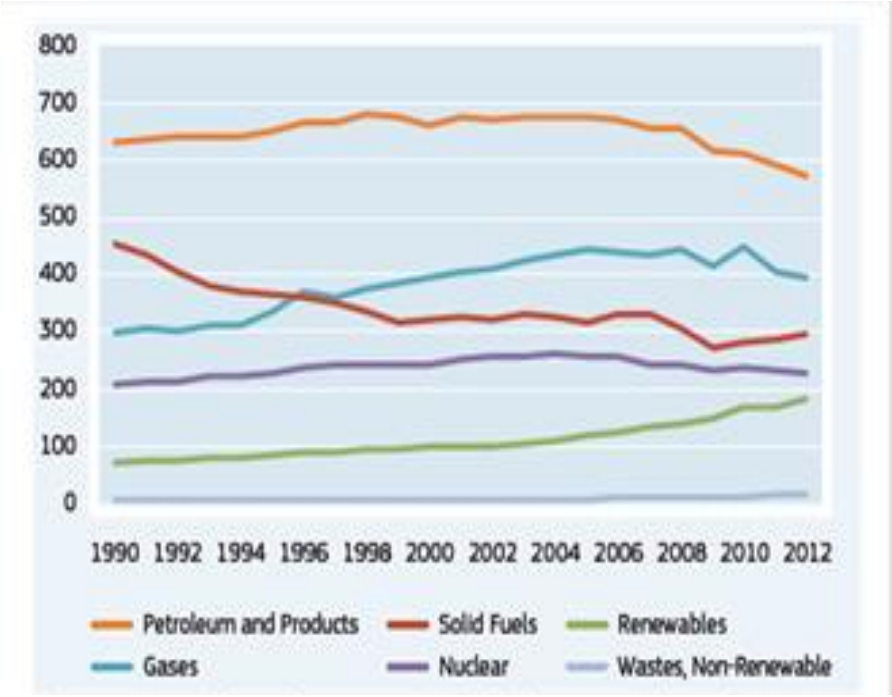


Figure 1: Gross inland consumption by fuel (Mtoe) –EU28 1990-2012. Source: European Commission 2014b

Second, the current trend of member states to unilaterally phase out or reduce their nuclear industries - much thanks to the Fukushima disaster – is expected to have a positive impact on the demand for natural gas. Spain, a country in which nuclear energy accounted for 12.5 percent of gross inland energy consumption (GIC) in 2012, have prohibited the building of new reactors (Bøhmer, 2015, p. 53). France has decided to reduce the share of nuclear energy in its energy mix, from 75 percent to 50 percent by 2025, and Germany has decided to phase out the industry completely (Bøhmer, 2015, p. 53). As nuclear power accounted for around 8 percent of Germany's GIC in 2012, and coal accounted for some 12.14 percent the same year, it is obvious that a rather large share of the German energy consumption must be found elsewhere - the natural replacement being either natural gas or renewable energy. This is also true for France (see figure 2). It remains to be seen however, whether or not this trend is a lasting one, as overall concerns for energy security might just as easily bring about a new era for nuclear power as it offers an indigenous source of energy. The impact of a reduced share of nuclear power in the EU-28 energy mix on the demand for natural gas is thus uncertain.

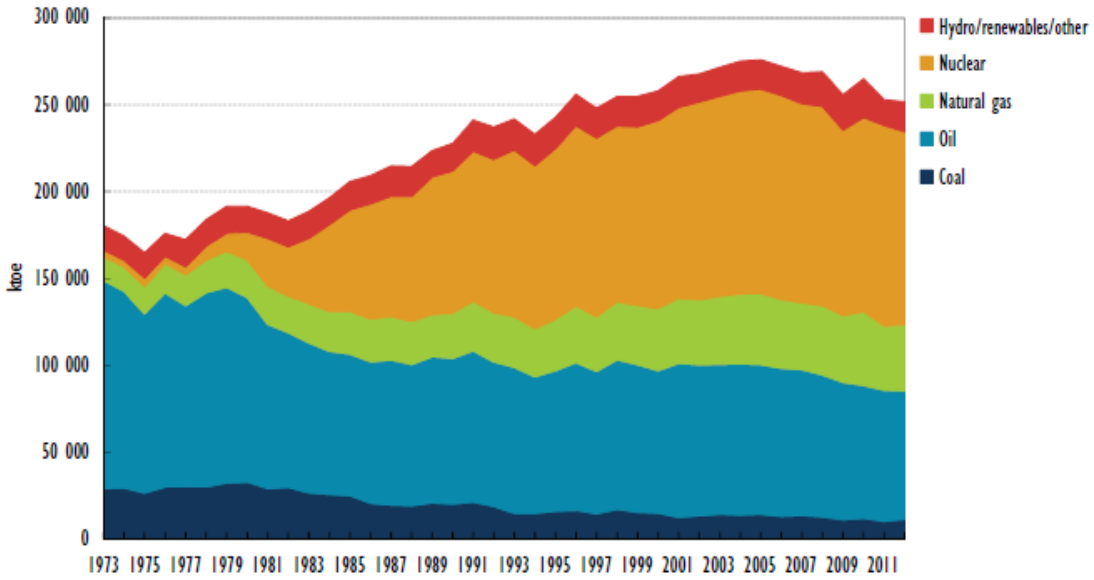


Figure 2: France, energy mix by fuel – trend 1973-2012. Source: IEA 2014, p. 185

Third, the production of indigenous resources is in decline (see figure 2). The fact that The UK - the union's second largest producer of natural gas – changed status from net exporter to net importer of gas in 2004 is a telling evidence of this trend (EIA, 2014a). In 2012, nearly 50 percent of UK gas demand had to be covered by imports (European Commission, 2014b, p.72). A similar trend of operative fields being exhausted has been visible in Denmark since 2004, a net exporter to Sweden and Germany (Danish Energy Agency, 2012, p. 6). In the Netherlands – the Union's largest gas producer and a net exporter- output from the Groningen field, the country's largest, have been temporarily halted due to the risk of earth quakes associated with gas extraction, and is also in a general decline similar to that of the UK and Denmark (Reuters, 2015).

Although some developments pull in the opposite direction – like the yet-to-be recovered drop in demand due to the financial crisis, as well as the reductions in EU gas demand that has resulted from improved energy efficiency across the Union – they are not big enough to

offset the opposite trend. In Franza (2014), twelve different scenarios on the future gas demand of the EU were compared and harmonized. In ten out of twelve, gas demand was expected to grow after 2015 (Franza, 2014, p. 30). As all increases in demand must be covered by imports, import dependencies across the Union must necessarily increase.

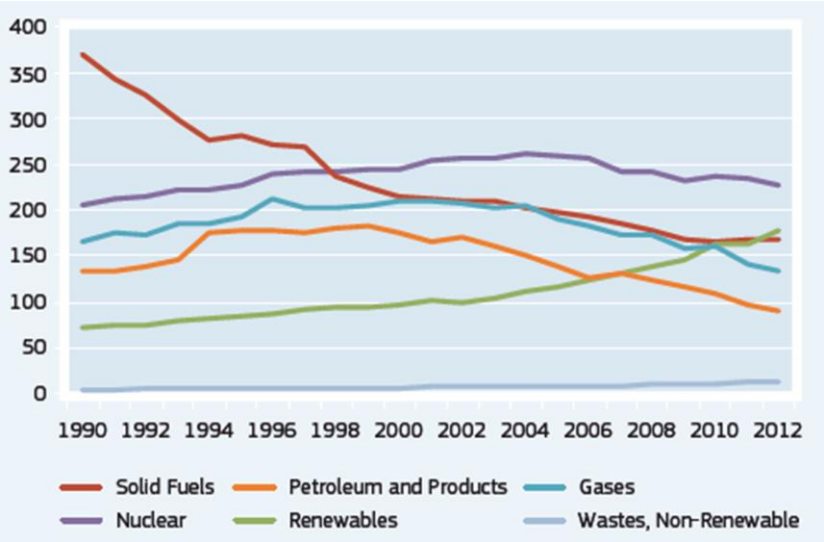


Figure 3: EU28 production by fuel (Mtoe) – 1990-2012. Source: European Commission 2014b, p. 37

While the overall import dependency of natural gas has increased when looking at the Union as a whole, there is considerable variation across the union what regards the role played by natural gas in national energy mixes (figure 4). At one extreme we have the Netherlands, in which natural gas accounts for 42 percent of GIC (Holz et al., 2014, p. 2). Italy, Lithuania, Slovenia, and Hungary follow thereafter, with gas accounting for some 36-39 percent of the GIC (Holz et al., 2014, p. 2) At the opposite extreme we have Sweden, in which gas only constitutes a 2 percent share of the energy mix (Holz et al., 204, p. 2).

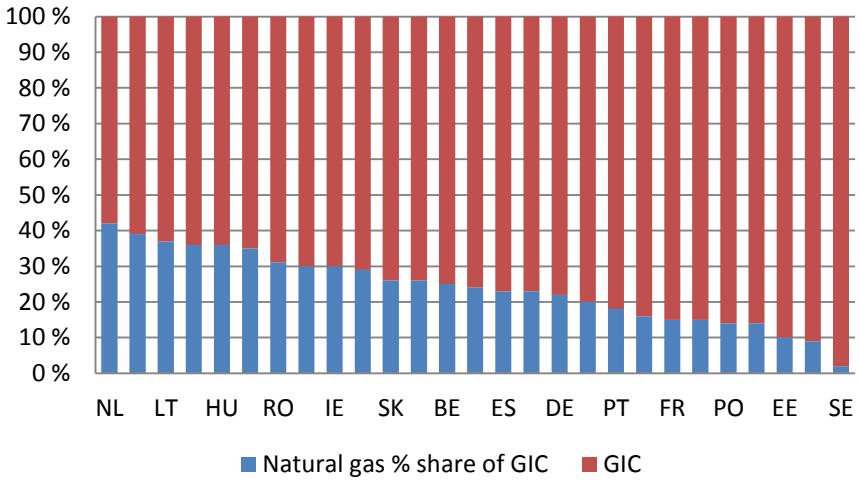


Figure 4: Share of natural gas in GIC, EU28. Source: Holz et al., 2014, p. 2

2.2 The road towards a common market for natural gas

The structure of the EU natural gas market has undergone profound changes over the past two decades, and the Union is currently in the transition towards a common market (the process will not be dealt with in detail here except where it serves the purpose of this thesis. The subject has been covered in detail elsewhere, e.g. in Eikeland (2011) and Buchan (2009)). While officially established in 1998 with the first of the so-called 'gas directives' of the liberalization process – more specifically, directive 98/30/EC concerning *common rules for the internal market in natural gas* (OJ L 204, 1998) – the market remains fragmented, still consisting of national sub-markets due to lack of interconnection between national sub-markets. Prior of the liberalization process, the EU gas market consisted of separate national markets, many of which were dominated by a vertically integrated 'national champion'. The national champions was state owned or heavily regulated private gas undertakings, often engaged with activities along the entire supply chain, from production and imports, transportation and storage, to distribution and sales to end users (Buchan, 2009, p. 39; Cronshaw et.al., 2008). As such, there was no common market in a physical sense at the time of the adoption of the first gas directive, although transit pipelines often crossed national borders. The efforts to liberalize the national markets so as to open them up to competition are founded upon a belief that cross-border flows, as would result from a fully

integrated common market, will alleviate security concerns related to gas supplies, as gas would be able to flow according to demand. As competition is assumed to create lower and more uniform prices across the market, this would increase the competitiveness of the Union's energy-dependent industry. With the U.S shale gas revolution, EU energy costs are currently comparatively higher, thus making the industry less competitive at the global market (Financial Times, 2015). It has also been argued that:

> "The freedoms which the Treaty guarantee the citizens of the Union…the free movement of goods, the freedom of establishment and the freedom to provide services – are achievable only in a fully open market, which enables all consumers freely to choose their suppliers and all suppliers freely to deliver to their customers" (OJ L 211, p. 94).

To this date however, despite the adoption of two new and increasingly more ambitions gas directives – Directive 2003/55/EC (OJ L 176) and Directive 2009/73/EC (OJ L 211) - the EU gas market is still incomplete both what regards levels of physical integration between sub-markets and what regards levels of competitiveness between markets that are interconnected. While the western part of the EU market is mostly liberalized and interconnected, the same does not hold true for many of the national sub-markets of Eastern Europe, the most extreme example being the Baltic States and Finland which are all completely isolated from the EU gas grid. These member states are therefore often referred to as 'energy islands'. This discrepancy in interconnectedness and liberalization has created a divide within the common market, in which the western part pays significantly lower prices than what does the eastern part. This hampers the overall functioning of the common market.

Much of the explanation for the inertia of the liberalization process can be found in the inherently monopolistic nature of gas supply. As the transportation of natural gas depends on extremely expensive and inflexible pipeline connections between seller and buyer, gas trade is by nature *exclusive.* What is more, due to the high investment costs (which are sunk) associated with exploration and development of gas fields, the extraction of natural gas, and the construction of transport-pipelines, in addition to the long lead times on such projects, long-term and large-scale commitments between the involved parties are necessary to make

the industry economically viable. In order to ensure that all parties are secured pay-off for their investments, gas is contracted in long-term supply contracts, often with a lifespan of 20 to 30 years. Such contracts have traditionally been used by EU gas undertakings when signing supply contracts with suppliers (Holz et al., 2014, p. 22). So-called 'take or pay' clauses are often included in these contracts, obligating the seller to provide a certain quantity of gas to the buyer, and the buyer to pay for a minimum of this quantity, regardless of whether or not they are actually 'taken' (Holland and Phillip, 2008, p. 610). In this way, security of supply and demand is secured for the buyer and seller respectively. By virtue of long-term supply contracts, the demand capacity of the buyer is 'locked' to a specific seller for long periods of the time. This makes new entries to the market difficult, as there might not be enough spare demand to justify the construction of a competing pipeline. As ownership over supply pipelines traditionally has belonged to the specific buyer and seller, third party access has not been granted to competitors as such competition would reduce the market share of the seller or buyer. Thus, gas supplies are by nature monopolistic, tying a specific market to a specific byer. In order to overcome the problem of natural monopolies, the granting of non-discriminatory third-party access to pipelines has been made mandatory for all owners operating within the EU gas market (OJ L 211, art. 32). However, as vertically integrated companies have an interest in denying third party access to competitors, it was deemed necessary to support the statutory third party access with a legal separation of transmission interests from the overall commercial interests of gas undertakings, so as to create an independent, common energy carrier for the market as a whole (Buchan, 2009, p. 25). Through so-called structural unbundling, undertakings are no longer allowed to at the same time be engaged in transmission, supply and production activities (OJ L 211, art. 9).

2.3 **The current structure of EU gas supplies**

Both national and international gas companies are engaged on the EU gas market. Due to the above mentioned unbundling requirement, all of the major national energy companies in Europe now operate with various subsidiaries that are in charge of either production, imports, transmission or distribution. The figure below illustrates the various steps of the natural gas supply chain

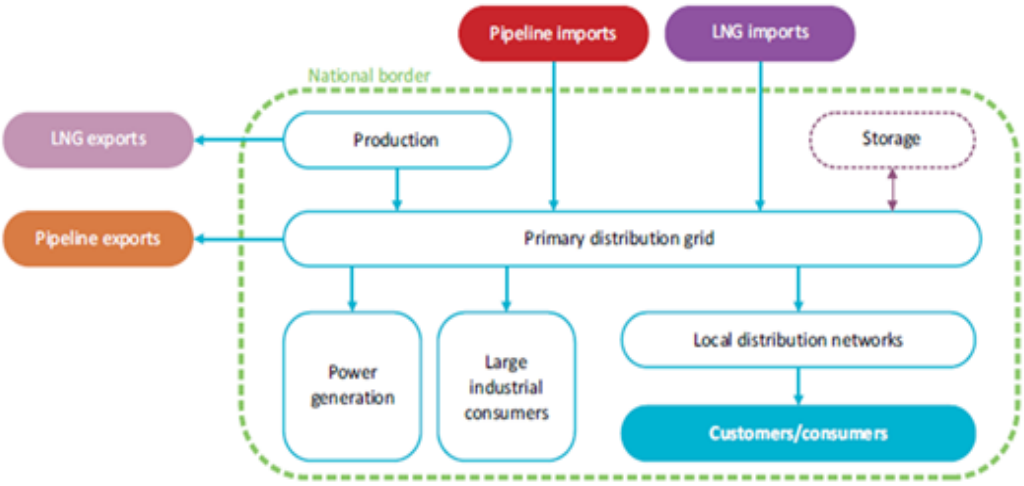


Figure 5: Natural gas supply chain. Source: IEA, 2014, p. 53

In this thesis, I deal solely with the transactions that occur between extra-EU producers and EU wholesalers in the upstream supply pipelines – that is, in the segments called "pipeline imports" in the figure above. These wholesalers – henceforth referred to as national companies – negotiate long-term supply contracts with suppliers and are in charge of bringing the gas volumes to the primary distribution grid. Traditionally, oil-indexation has been used to determine the contracted prices, meaning that the price for gas is pegged to that of oil, as these two fuels are considered close substitute. While hub-indexed prices are also used, based on the gas-on-gas competition at the various EU hubs, some form of oil-indexation is still preferred by suppliers. From the primary distribution grid, the national companies either sell their imported volumes to large industrial consumers or to the retailers, who subsequently sell the volumes to local distributers or end users. Although not necessarily national companies, I use the term to signify that, despite efforts at increasing cross-border trade, the now unbundled national champions still hold the dominant market share in their traditional home markets. As security of supply is vital for the functioning of national economies, governments are often highly engaged in the activities of their old national champions, cheering them on through subsidies or good diplomatic relations with producer countries (Buchan, 2009, p. 39).

One reason why Russia is able to exercise market power is that the supply contracts agreed upon by producers and national companies are wholly exempt from compliance controls

with EU law prior of ratification. As such, if non-compliance is uncovered, the contracts are already operative, making unilateral termination by the hands of the Commission competition authority difficult, as such termination might be a violation of contractual law.

The EU-28 imports gas from a number of external producers, some of which play a decidedly more prominent role as suppliers than others. Russia and Norway are by far the largest suppliers of gas to the EU, accounting for 32 and 31 percent of the total EU-28 gas imports respectively (European Commission, 2014b, p. 65). Supplies from Algeria Qatar, Nigeria, Libya, and Trinidad and Tobago follow thereafter (European Commission, 2014b, p. 65). Figure six illustrates the composition of EU gas imports according to country of origin.

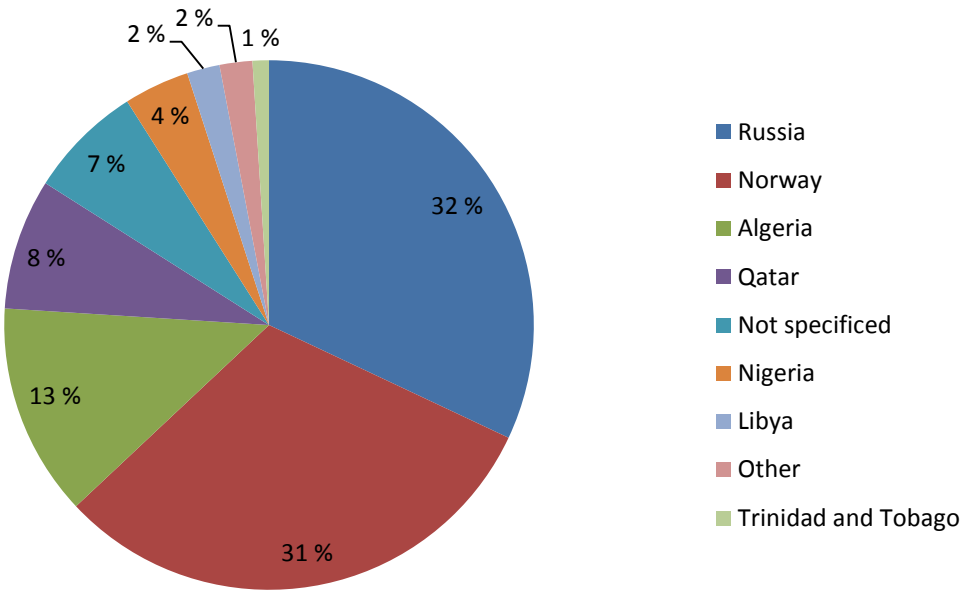


Figure 6: EU natural gas import from extra-EU producers, 2012. Source: European Commission, 2014b, p. 26

Chapter 3: Understanding Russia's market power – the historical origin of EU-Russian gas trade

A short introduction to the historical origins of the current EU-Russian gas trade is provided in this chapter. In order to understand the complexity of the regulatory dispute that is currently playing out between the EU and Russia, it is helpful to have a clear picture of the origins of Russia's market power within the EU. The current EU-Russian gas trade is founded upon, and mostly still structured according to, two separate trade relationships that developed between at the one hand what was then the Soviet Union, and at the other hand two groups of European states – those of Western Europe and those of Central and Eastern Europe. The latter group was more or less subjected to Soviet control at the time. The historical remains of the different ways in which the Soviet Union's gas trade with these two groups of European countries developed co-exist uneasily within the current EU-Russian gas trade, and it is much due to the one sided efforts of the EU to liberalize its gas trade that the current relationship between the two has become strained.

3.1 The Cold War era - the development of the Soviet Union's export market

Although the Caucasus and Central Asia had provided the Soviet Union with gas under the post-war era, it was the discovery of vast gas reserves in western Siberia in the early 1960s that really prompted the development of the Soviet gas industry. In order to connect the new field with the major industrial centers of the Soviet republics, the Soviet Ministry of Gas launch the development of what became the Unified Gas Supply System (UGSS) - an extensive domestic network of pipelines with branches extending into the larger political sphere of the Soviet Union (Ericson, 2009, p. 30). The entire supply chain of the UGSS was owned by the Ministry, which thus had vertical control over all aspects of the Soviet gas industry, from production and transportation to storage and supply (Ericson, 2009, p. 30). This network was connected to existing gas fields and extended by virtue of an export pipeline to the then-border of Western Europe, through which the Soviet Union began exporting large quantities of natural gas in the early 1970s – specifically to Austria, France, Italy and Western Germany. This gas trade was agreed upon on mutually beneficial grounds. While the Soviet Union needed to boost its suffering economy with export revenues, parts of which it could use to import much needed manufactured goods from Western Europe, the Western European states were eager to diversify their supply portfolio away from Middle

Eastern oil, as OPEC had proven itself an unreliable supplier of energy during the 1973 oil embargo (DCI, 1982, p. 17-18). The Soviet market for goods, in turn, provided a golden opportunity for Western Europe to bolster its industry, which suffered a downturn in the early 1980s (Ericson, 2009, p. 30, footnote 5). Through so-called "pipe for gas" agreements, the Soviet Union was granted government-backed loans from these Western European countries, which in part was provided as pipes and other gas-related equipment that the Soviet Union needed in order to develop its gas industry (DCI, 1982, p. 17). In exchange, the Soviet Union agreed upon long-term supply contracts with these countries, some lasting until the year 2000 (DCI, 1982, p. 17). The gas volumes agreed upon in these contracts were to be delivered through a new export pipeline whose construction was agreed upon by the contracting parties in 1979 (DCI, 1982, p. 17). As natural gas was regarded as a substitute for oil due to their complementary use, the contracting price was pegged to the global oil price. Such oil indexation was believed to provide predictability to all involved parties, as well as provide as buffer against unfair pricing (DCI, 1982, p. 29). Compared to OPEC oil, Soviet gas was perceived as a reliable source of energy despite the context of the Cold War because it was known that the Soviet Union could not afford to divert from its part of the deal. It needed to "maintain its hard currency earnings and to preserve its reputation as a reliable trade partner" (DCI, 1982, p. 29). Precautions were nonetheless taken; in order not to give the Soviet Union too much of an upper hand vis-à-vis Western Europe, it was decided that Russian gas should not account for more than a maximum of 30 percent of the national energy mix (Cronshaw et al., 2008, p. 13).

When we turn to the historical development of the Soviet Union's gas trade with what is now the easternmost Member States of the European Union, the story is a wholly different one. As can be seen in figure 7, the post-World War Europe was parted in two - the Baltic States (Estonia, Latvia and Lithuania) being wholly immersed in the Soviet Union as so-called 'Soviet republics', as were the important transit countries Ukraine and Belarus. The Soviet Union also expanded to include several other European countries and the resource rich Central Asian countries. Current EU members that were then part of the larger eastern bloc by virtue of being so-called 'satellites' included what was then East Germany and Czechoslovakia, as well as Poland, Hungary, Romania and Bulgaria, all of which were subjected to Soviet rule both politically and economically, albeit without being immersed in

its geographical sphere. These satellites and republics helped Soviet expand its gas industry by developing specific sectors of their heavy industries in accordance with the Soviet strategy of product specialization so as to be able to provide the Soviet Union and other satellites with much needed manufactured goods and infrastructure (Cronshaw et al., 2008, p. 18) In return, the satellites and republics were subsidized with Soviet gas at a symbolic price, provided thorough the UGSS – the so-called "gas for manufactured goods" principle (Cronshaw et al., 2008, p. 18). For this reason, the independent states that reemerged with the disintegration of the Soviet Union were all heavily underdeveloped and highly dependent on cheap Soviet gas.

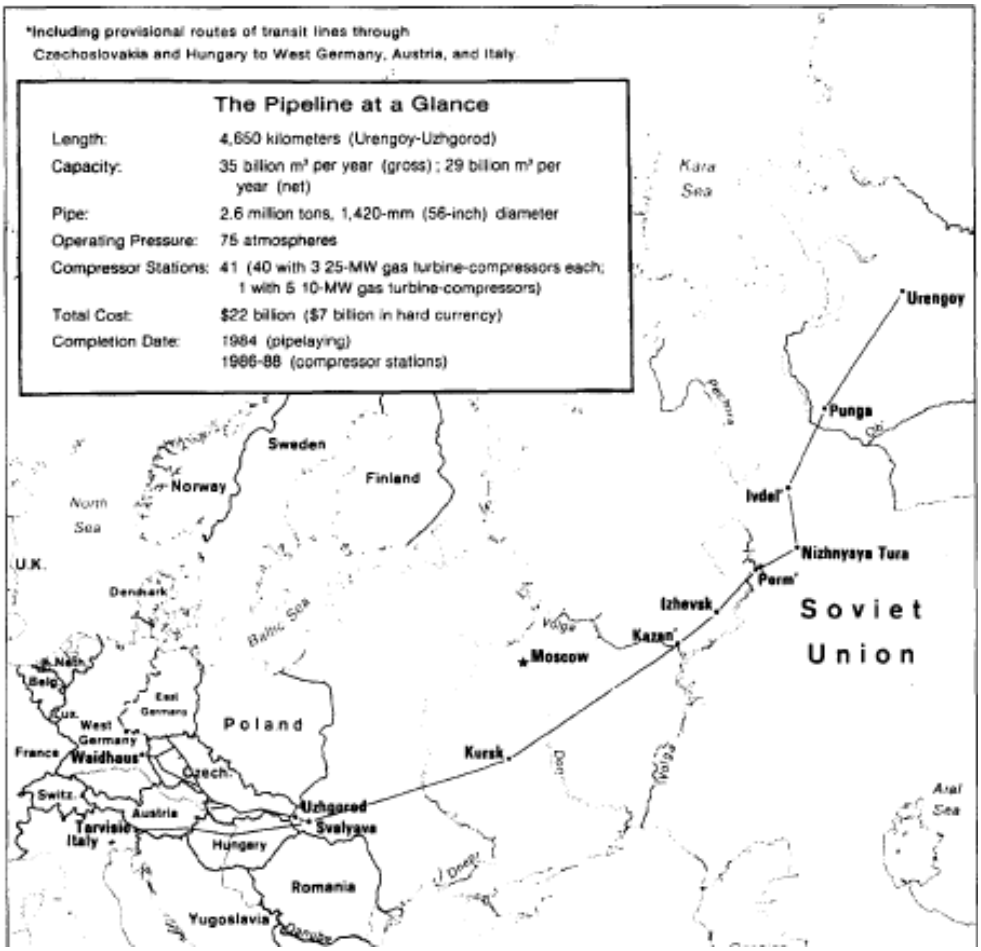


Figure 7: Map of Soviet export pipeline to Western Europe. Source: DCI, 1982, p. 18

3.2 **The post-Soviet era - the birth of Gazprom and the rise of Putin**

With the disintegration of the Soviet Union, The Soviet ministry of gas was morphed into the de facto state-owned gas company Gazprom, of which the Russian state holds a 51 percent ownership share (Müller-Kraenner, 2008, p. 39). Today, Gazprom is the world's largest gas company with its some 20 percent share in the global market, and it holds the world's largest reserves of natural gas as well as the seventh largest reserves of oil (Müeller-Kraenner, 2008, p. 38). By virtue of its historical origin, Gazprom inherited ownership over the UGSS and the various storage facilities of the former Soviet Union. As such, Gazprom inherited a predominant position as monopoly supplier to the Russian market as well as a monopoly over export to Europe – a monopoly which is currently sustained by law in order to keep Russian or other competitors out of the pipelines (EIA, 2014, p. 10). What is more, despite the emergence of several formally independent producer states from behind the iron curtain, most notably the Central Asian countries, "all export pipelines still ran through Russia and were controlled by Gazprom (Ericson, 2009, p. 32). Thus, due to history, Central Asian producers wishing to sell gas to Europe must first sell it to Gazprom, who subsequently exports it to Europe (Ericson, 2009, p. 32). As such, in addition to having a national export monopoly, Gazprom also has a buyer monopsony over most of the Eurasian gas (Ericson, 2009, p. 32).

During the 1990s, the gas administrations that had been operative within the Soviet republics and satellites were turned into national gas companies (Cronshaw et al., 2008, p. 22). While Gazprom continued to subsidize gas supplies to existing allies, those that moved closer to the EU in hopes of one day gaining membership had to enter though renegotiations with Gazprom, which unilaterally replaced the symbolic price of the Soviet era with hard currency prices (Cronshaw et al., 2008, p. 22).

Although still owned by Russia, the UGSS now expanded into several independent countries. As such, where Russia previously had control over its exports to Western Europe right up to the border of the East-West divide, Russian gas destined for Western Europe now have to transit through a 'wall' of independent countries in Central and Eastern Europe (Ericson, 2009, p. 33). This, however, did only become a problem for Russia after the accession of many of these countries to the EU by virtue of two eastern enlargements in 2004 and 2007. By 2007, the Baltic States, Poland, the Czech Republic, Slovakia and Hungary were granted

EU member ship, a fact which meant that parts of the UGSS were now subjected to the EU energy acquis regulating the common gas market. Due to the high import dependency of these countries, ensuring a proper implementation of the energy acquis has been regarded a priority for the EU. Such implementation, however, would require Gazprom to allow third party access to parts of the UGSS and separate out the operation of the pipelines to an independent operator. This would in theory signify the end of Gazprom's monopoly – although maybe not in reality, given that the relevant markets are subjected to vertical foreclosure due to existence of long-term supply contracts that ties demand to Russian gas (Buchan, 2009, 29).

The current problem facing the EU-Russian gas trade is the overlap of regulatory spaces in the intersection between the old Soviet border and the newly extended border of the EU (and the Energy Community), both being extension of very diverging political goals (Grätz, 2011, p 62). While the EU seeks to find a way in which the Union's rising import dependency can be decoupled from the political influence that flows from energy dependence, Russia under Putin seeks to consolidate its political power through energy exports. The two are thus pursuing completely opposite energy strategies. Russia has repeatedly argued that it will not comply with the requirements of third party access and unbundling – it is a red line that it won't cross (Lamy, 2004). From a Russian perspective, the rejection of the market liberalization is understandable. As argued by Leonard and Popescu (2007), "From Russia's perspective, the West has spent the last two decades rewriting the rules that govern their relationship"- a process which Russia for a long time had to accept due to its lack of economic and political power in the immediate aftermath of the Cold War (Leonard and Popescu, 2007, p. 19). Now, however, with a booming economy and the coming to power of Putin in 2000, "Moscow is seeking to revise the post-Cold War settlement itself. It does not want to become part of the West anymore and it is challenging all the strategic, political and economic agreements that were signed in the 1990s" (Leonard and Popescu, 2007, p. 19). Under Putin the brief period of "wild privatization" that followed the collapse of the Soviet Union has been replaced by an assertive new policy of "state-monopolist capitalism" (Müeller-Kraenner, 2008, p. 41). Through tightening the control over its energy resources, Russia is seeking to consolidate its power so as to once again become a great global power

(Müeller-Kraenner, 2008, p. 54). The conflict boils down to the very geopolitical question of who gets to determine the rules of the gas game.

Chapter 4: The Russian energy stranglehold- an issue of market power

In this chapter I present the foundations for Tusk's claim that Russia has an energy stranglehold on the EU. Common allegations that are often raised against Russia and the activities of Gazprom within the EU market will be explored, followed by an overview of the Commissions current antitrust case against the company.

4.1 Common allegations against Russia and Gazprom – the 'divide and rule' strategy

The Russian energy stranglehold analogy refers to specific actions made by Gazprom at the EU gas market. I mentioned above that Gazprom has made use of the opportunities for market participation offered by the EU market opening and liberalization. Through so-called forward integration, Gazprom has been able to buy its way into the downstream segment of the EU market and is now participating as a shareholder in European companies operating along the entire supply chain. At the same time, Russia refuses to give these companies reciprocal access to the Russian upstream sector, and many are therefore arguing that Gazprom is taking unduly advantage of the EU market liberalization, offering little in return (Finon and Locatelli, 2008, p. 2). One allegation that has been raised in relation to this is the argument that Gazprom is using forward integration (integrating into lower levels of the supply chain) to segment the various national markets, effectively hampering competition through a 'divide and rule' strategy which allows the company to price-discriminate between its buyers (see figure 8) (Krastev, 2015).

It is feared that this strategy will allow Gazprom to "use the opportunities of gas market liberalization in order to undercut the EU's liberalization and market homogenization agenda", and in that way sustain its ability to charge higher-than-competitive prices (Grätz, 2011, p. 63). Russia is also accused of encouraging Turkey to oppose the planned construction of the Southern Corridor, a pipeline which would allow the EU to access gas from the Caspian basin while circumventing Gazprom's pipelines (Finon and Locatelli, 2008, p. 2). In addition, Gazprom is cooperating with the Algerian company Sonatrach, the main exporter of Algerian gas to the EU, and together they have formed a joint venture for the exploration and development of new fields in Algeria (Reuters, 2014). Given these developments, avoiding Gazprom seems impossible, and many are arguing that Gazprom

attempting to encircle the EU market, shutting it off from alternative suppliers (Finon and Locatelli, 2008, p. 2).

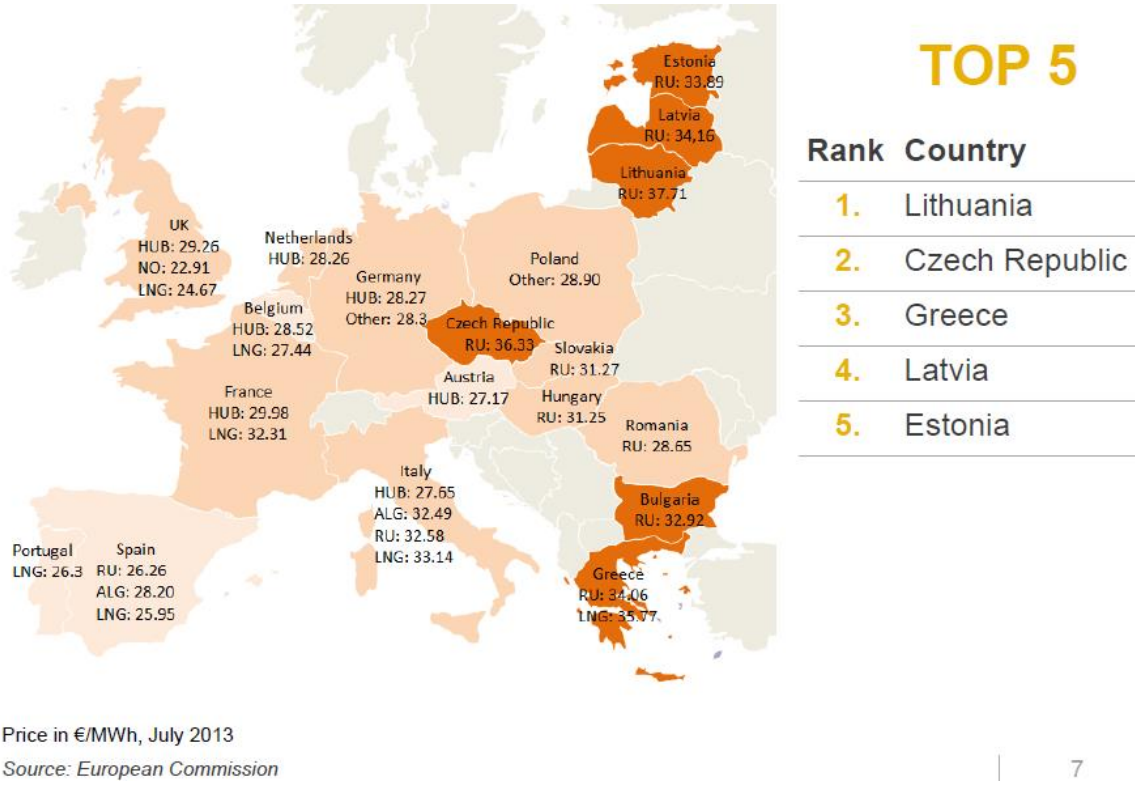


Figure 8: Comparison of EU wholesale gas prices by country. Source: Matulionis, 2013, p. 7

4.2 The Commission's antitrust case against Gazprom

4.2.1 Background – unannounced inspections

In August 2012, the Commission opened formal proceedings against Gazprom (European Commission, 2012). The background for this case is an unannounced inspection of Gazprom's activities in Central and Eastern Europe carried out by Commission officials in 2011, which results indicated breaches on EU antitrust legislation (European Commission, 2011a). The unannounced inspection and subsequent proceedings against Gazprom is part of the Commission's overall effort to ensure compliance with the electricity and gas directives that governs the internal market, a process that started in 2005 with the 'Sectoral Inquiry' into the Western European market for electricity and gas (Riley, 2012, p. 6). In the inquiry it was uncovered that there prevailed widespread anti-competitive activity throughout the market, a fact that went largely unnoticed by the public media (Riley, 2012,

p. 6). The high level of vertical integration still characterizing many of the national gas companies was among the most disturbing discoveries. In addition, evidence indicated extended "vertical foreclosure of national markets, combined with lack of cross-border sales and of market transparency and defective price formation" (Riley, 2012, p. 6). On the basis of this inquiry the Commission prosecuted several of the West-European energy companies, including the big champions EFD, GDF/Suez, E.ON and RWE (Riley, 2015, p. 6). With the two eastern enlargements a new inspection was due in 2011. The countries that joined the EU in the 2004 enlargement (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia) were not included in the 2005 Sectoral Inquiry as the energy markets of these countries had yet to be adapted to the energy acquis by the time of the inquiry. As such, the 2011 inspection, which included countries from both the 2004 and the 2007 enlargement (Bulgaria and Romania), was the first of its kind for these countries (Commission, 2011a).

4.2.2 The Commission's allegations

Gazprom is accused for being in breach of TFEU art. 102, which prohibits "Any abuse by one or more undertakings of a dominant position within the internal market in so far as it may affect trade between Member States" (OJ C 326). According to this article (TFEU, art. 102.(a)-(d)), abuse of a dominant market position may in particular consist in actions such as:

a) Directly or indirectly imposing unfair purchase of selling prices or other unfair trading conditions;
b) Limiting production, markets or technical development to the prejudice of consumers;
c) Applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
d) Making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature of according to commercial usage, have no connection with the subject of such contracts.

Gazprom is accused of acting contrary to all of the above mentioned actions. In a Commission memo it is stated that "…the Commission's preliminary view is that Gazprom is

breaking EU antitrust rules by pursuing an overall strategy to partition Central and Eastern European gas markets with the aim of maintaining an unfair pricing policy in several of those Member states" (European Commission, 2015b). This strategy is allegedly based on three illegal activities: imposing territorial restrictions that hinder cross border gas sales; charging unfair prices; including non-commercial clauses in the supply contract thus making supplies conditional upon unrelated commitments. The accusations against Gazprom raised by the Commission are elaborated on below (for illustration, see figure 9).

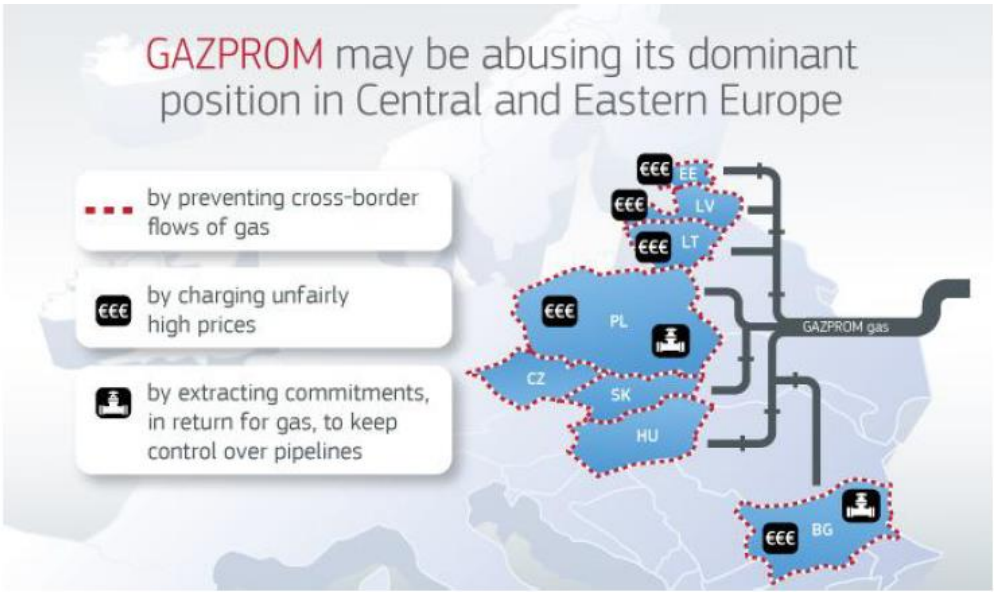


Figure 9: Illustration of the Commission's allegations against Gazprom. Source: European Commission, 2015b.

4.2.2.1 Hindrance of cross border gas sales

According to the Commission, Gazprom is accused of including contractual clauses that hinders cross-border trade of imported gas (European Commission, 2015b). Specifically, from its investigations into the procedures of Gazprom, the Commission expects to uncover the use of *export ban clauses* and *destination clauses* in the supply contracts between Gazprom and the relevant EU member states. The former refers to "provisions that explicitly prohibit the export of gas" after the gas has reached its original destination – that is, it prohibits the re-sale of gas-, the latter refers to "provisions that stipulate that the customer… must use the purchased gas in its own country or can only sell it to certain customers within its country" (European Commission, 2015b). In addition, the Commission accuses Gazprom from including "other measures that prevent the cross-border flow of gas,

such as requesting wholesalers to **obtain Gazprom's approval prior of any re-sale or exports,** or the **refusal to change the delivery points** of supply flows (European Commission, 2015b).

The use of such territorial restrictions prevents gas from flowing freely between the affected member states, as well as between these states and the Western European gas market. As such, the relatively cheaper gas in Western Europe is kept from the Eastern and Central European sub-markets, effectively allowing Gazprom to maintain a higher price in these than would have been possible had there been competition. This leads to market partitioning and "hinder gas from flowing where it is most needed and where prices are commercially most attractive" (European Commission, 2015b). Several European companies have previously been found guilty of anticompetitive behavior due to the use of such territorial restrictions, including the French company GDF and the German company E.ON (European Commission, 2009).

4.2.2.2 Charging unfair prices

The Commission is investigating whether or not the pricing mechanism applied in Gazprom's long-term contracts with Central and Eastern European buyers is the cause for these Member States paying relatively higher gas prices than what does the Western European Member States. The preliminary conclusion reached by the Commission is that much of the unevenness in prices are caused by the specific price formulae applied by Gazprom, as is has been proven to favor the company's revenues at the expense of the price it can offer buyers (European Commission, 2015b). This does not, however, mean that the Commission in general regards the use of oil indexation as an unfair price mechanism. The Commission has so far reached the conclusion that Gazprom has charged unfair prices in Bulgaria, Estonia, Latvia, Lithuania and Poland (European Commission, 2015b). In its investigations, the Commission has compared the national gas prices with a number of benchmarks, such as "Gazprom's costs, prices in different geographic markets or market prices" (European Commission, 2015b).

4.2.2.3 The inclusion of non-commercial clauses in supply contracts

On this point, the allegations raised by the Commission are specific to Gazprom's activities in Poland and Bulgaria. In Poland, the Commission argue that Gazprom has made the gas supplies to the polish market "conditional upon maintaining Gazprom's control over investment decisions" concerning the Yamal pipeline - one of the key transit pipelines in Poland, through which non-Russian supplies could enter the Polish market (European Commission, 2015b). As such, Gazprom is accused of hindering Polish attempts at diversifying their supply portfolio. In Bulgaria, the allegations are based on the Commission's view that Gazprom has made supplies to wholesalers conditional upon the participation of the country's main wholesaler in the South Stream pipeline project, despite the project having an economically unsound profile (European Commission, 2015b). Although this project is now cancelled (or halted), the accusation is based on the belief that Russia was attempting to undermine a competing pipeline project – the Blue stream pipeline – which, had it been successful, would have allowed EU gas imports from Uzbekistan, Kazakhstan and Turkmenistan, thus circumvent Russian gas and pipelines.

4.3 **The Russian response**

As the Commission faces no legal deadline for completing antitrust inquiries, the case against Gazprom can go on for a while (European Commission, 2015b). A protracted proceeding is also the expected outcome, as Gazprom is showing no signs of willingness to cooperate. In fact, quite the opposite has been the case, and Gazprom is backed by political resistance to the case in Moscow. When it became clear that the Commission had started procedures against Gazprom, a spokesman for the company made the following statement:

> "The actions of the European Commission… can only be seen as an attempt by the [commission] to pressure Gazprom and influence prices and the results of commercial negotiations, which is clearly in breach of market principles… Right now, a series of relatively weak EU economies are continuing to demand from Gazprom unilateral concessions on gas prices. You can't view this as anything other than EC support for Gazprom subsidies to eastern Europe. This is an attempt to solve the economic problems of the EC at Russia's cost" (Belton et al., 2012).

In response to the proceedings - to illustrate just how much they resent the case - Moscow adopted the 'blocking statute', a decree that "aims to protect 'strategic' companies operating abroad, demanding that any foreign organization requesting information, assets or changes to contracts from strategically important companies must first seek permission from the Russian government" (Belton et al., 2012). Moscow is thus trying to deny the Commission from exercising its 'power of inspections' (OJ L1).

In April this year, almost three years after the official proceedings were initiated, the Commission issued a 'Statement of Objectives' to Gazprom, effectively making known to the company on what issues the anti-trust case raised against it is being pursued. This document is issued according to the procedure laid out in Council Regulation 1/2003 on the implementation of the competition rules (OJ L1), which states that the burden of proving an infringement of the relevant article (in this case the prohibition in TFEU art. 102 of the abuse of a dominant market position) "shall rest on the party of the authority alleging the infringement" (OJ L1, art. 2). Gazprom's right of defense according to art. 27 of the regulation is the only step that remains before the Commission can take a final decision in the case. It is now up to Gazprom to reply to the accusations and attend an oral hearing before the Commission and the national competition authorities of the parties involved (European Commission, 2015b).

The outcome of the case is uncertain and both sides are claiming that the other is in the wrong. What make this case so special is the political ties of Gazprom to Moscow – essentially making this a dispute between The EU and Russia, elevating the case to the political level. It is a dispute between two ideologies of market participation. Where antitrust cases raised by the Commission against companies operating within the EU market are usually solved by private settlements, no such settlement is believed possible in the case against Gazprom (Riley, 2012, p. 1). As Riley argues, due to the exceptional political and economic circumstances of this case, it may be

> "…subject to full European antitrust process; a prohibition decision with fines attached, a series of legal challenges by Gazprom to the EU General Court and

> onward to the European Court of Justice… its importance derives from the prospect that the case may lead to the dismantling of the Gazprom model…" (Riley, 2012, p. 2).

Regardless of the truthfulness of the Commission's allegations, they represent the *energy stranglehold* referred to by Tusk. Gazprom's enormous market share in the EU gas supply makes Russian exploitation hard to avoid under the current structure of supply. Tusk's proposal to fight power with power has been presented as a possible solution.

Chapter 5: The Polish proposal – evoke the EU's countervailing power

In this chapter I explore the details of the Polish Proposal. I start off by debunking some of the myths related to the content of the proposal, which have been the source of much of the criticism raised against Tusk's vision.

5.1 Debunking the myths

The essence of the Polish Proposal was neatly, albeit misleadingly, summed up by Tusk himself in his financial times article *A United Europe can end Russia's Energy Stranglehold;*

> "...Europe should develop a mechanism for jointly negotiating energy contracts with Russia… Initially, bilateral agreements would be stripped of any secret and market-distorting clauses… a template contract would be created for all new gas contracts…" and "… the European Commission would be required to take a role in all new negotiations" (Tusk, 2014a)

Tusk has received substantial critique for his proposed supranational coordination of gas purchases (e.g. Beckman (2014), Siddi (2014), Oroschakoff (2015)). Much of this criticism is, however, misplaced. While it is true that the crux of Tusk's proposal is the coordination of gas purchases at the supranational level, he does not, as critiques argue, propose that the Commission shall take over the buyer role of the European gas undertakings. One critical voice that has certainly got it all wrong is Karel Beckman, editor-in-chief of the Energy Post, who wrote the following response to Tusk's proposal:

> "Who does Mr Tusk suggest anyway would run this 'Energy Union'? Mr Oettinger? Bureaucrats in Brussels would 'ensure' our gas supply from now on, set the prices, decide which member state gets how much, where the gas should be bought and at what price? Fortunately, most policymakers in Brussels are far too wise to be even tempted by such a far-fetched notion" (Beckman, 2014)

This ridicule of Tusk's proposal is actually based on a misquotation of his article. According to Beckman, Tusk suggests the breaking up of supply contracts and subsequently stripping them of secret and market-distorting clauses – a proposal Beckman believes to be contrary to the "…rule of law that I believe the EU is supposed to stand for – not some kind of 'solidarity' to be decided on and doled out by politicians" (Beckman, 2014). What Tusk

argues, however, is that "…Europe should undertake the lengthier task of breaking up the Russian gas monopoly and restoring free market competition". He has mentioned nothing about the unilateral breaking up of supply contracts. In fact, Tusk is explicitly clear on the fact that his proposal does not aim at altering the current division of competences between the member states and the EU institutions, as most certainly would have been necessitated should the Commission be able to determine from what suppliers and at what quantities the EU gas undertakings was to import;

> "This non-paper proposes a set of measures that address the EU's energy dependency challenges. Its implementation could lead to the creation of a genuine "Energy Union" in Europe. All the measures and instruments should be introduced based on the Treaties with full respect for the current balance of competencies between the EU institutions and Member States and the sovereign right of Member States to determine their own energy mix. The Lisbon Treaty has created legal basis for EU energy policy with full respect to the Member States' right to exploit and choose their own energy sources and structure their own energy supply" (Polish government, 2014, p. 3).

Thus, some nuances are added. While the term 'Energy union' definitively has a certain cachet, it does not really reflect the intentions of Tusk what regards his visions for the Union's external dimension – associative as it is with the decomposition of national decision making power over supply contracts in favor of a supranational single buyer. Rather, the essence of Tusk's proposal is that all extra-EU gas sellers should face uniform trade conditions upon entering into supply contracts with an EU-based gas importer. Put differently, the trade terms facing the supplier should be equal regardless of which EU country or company the contract is signed with. This does not mean that a regulated EU-wide price to be imposed – as Tusk is explicitly clear about – but rather that the price should not be influenced by anything other than market mechanisms (Tusk, 2014, p. 3). The relevant legislation that the Commission, via the Gas Supply Agency proposed by Tusk, could enforce under a single buyer structure is the EU competition rules and the gas market rules. The point of such uniform trade conditions is to eradicate the hindrance to the free flow of gas that non-competitive prices or various trade-distorting clauses represent. Even when assuming an ideal situation in which the interconnection across the EU gas market was

completed; if the gas that entered the market, originally identical in terms of quality, had attached to it unequal characteristics – most notably price -, the gas would not be able to compete with itself at the EU market. Regard, as an example, Russian gas sold to Germany and Hungary respectively; due to the price differences that is attached to these countries' respective supply contracts, Russian gas is unable to compete with Russian gas. The market would not function properly under such conditions. This logic, which is the foundation of Tusk's proposal, should be rather uncontroversial as it is the same logic that applies to the EU customs union. By virtue of the Customs Union, all exports to the EU internal market face the same customs duties upon entering the market. Within the market, however, cross-border customs are a thing of the past (European Commission, 2014, p. 3).

> "The EU customs union is managed on the ground by 28 national customs services of Member States acting *as if they were one*…The EU is the world's largest trading block, so in global terms, the EU customs union is a heavyweight in international trade. Its negotiating position thus outweighs that of any single Member State acting on its own" (European Commission, 2014, p. 3. Emphasis added).

The logic applied in the quote above is the same that Tusk argues should be applied to the EU gas sector. It is essentially the same logic that is applied by the Commission in its decision establishing an information exchange mechanism for the compliance control of bilateral intergovernmental agreements related to the EU energy market:

> "The proper functioning of the internal energy market requires that the energy imported into the Union be fully governed by the rules establishing the internal energy market. An internal energy market that does not function properly puts the Union in a vulnerable and disadvantageous position with regard to security of energy supply, and undermines its potential benefits to European consumers and industry (Decision 994/2012/EU, point 3)

I now turn to the details of Tusk's proposal.

5.2 **The Polish proposal**

According to Tusk, the member states "…should take the same approach with Russia's gas" as is done when the Union "…jointly buy uranium for their nuclear power plants through the

EU's atomic energy agency" (Tusk, 2014). Before I analyze the degree to which such coordination would create sufficient leverage for the EU to countervail Russia's market power, an introduction to the Atomic Energy Agency and the joint purchasing mechanism that lies therein is in order.

5.2.1 The Atomic Energy Agency

By the Atomic Energy Agency, Tusk refers to the Euratom Supply Agency (ESA). The agency is part of the larger institutional framework of the European Atomic Energy Community (Euratom), which foundation is a common market for nuclear materials. This market is governed by a common supply policy, and ESA was established to purchase nuclear materials for the Union as a whole – that is, as a supranational single buyer (Euratom treaty, art. 52.2.b). The composition of ESA and specification of its task is delineated in the Statutes of the Agency, which was laid down by the Council in 1958, and later amended in 2008 (OJ L 41). It suffices here to say that ESA is subjected to the supervision of the Commission, which has the right to veto any of the Agency's decisions (Euratom treaty, art. 53). In addition, the Commission appoints the Agency's Director General, which is to act as the representative of the Agency and ensure that its tasks are carried out according to law (OJ L 41, art. 3). As such, the responsibility for the Community's security of supply of nuclear materials is to be governed by Union policy, in contrast to security of supply of gas, which is still mainly at the national level. The member states are nonetheless present within the decision making structure of ESA via the Supervisory Committee, which is to serve as the link between the Agency and both producers and users in the nuclear industry" (OJ L 41, art. 13).

As a single buyer ESA has the responsibility to ensure the "regular and equitable supply of ores and nuclear fuels" (Euratom treaty art. 2.d) to all contracting parties (although Euratom is a separate treaty, it shares the same membership base as EU), on the basis of the principle of "equal access to sources of supply" (Euratom treaty, art. 52.1). To enable ESA to properly execute this task, it was granted two important mandates; the "right of option" on all relevant nuclear materials produced within the territory of the Community, and the "exclusive right to conclude contracts relating to supply…coming from inside the Community or from outside" (Euratom Treaty, art. 52.2.b). This latter mandate forms the basis for the joint purchasing mechanism that Tusk is eager to copy in the gas sector. I will disregard ESA's

right of option in the following analysis, as a Community ownership of natural gas would be contrary to Tusk's explicit statement that the current division of powers is not to be altered under his proposal.

5.2.2 ESA's exclusive right to conclude supply contracts

According to the Euratom Treaty, ESA is to have "an exclusive right to conclude contracts relating to the supply of ores, source materials and special fissile materials coming from inside the Community or from outside" (Euratom treaty, art. 52.2.b). Because the task of the Agency is to ensure an equitable supply on a non-discriminatory basis for all Community members, available supplies must be distributed strictly according to demand. To enable ESA to do so, article 60 of the Euratom Treaty states that potential users and producers shall inform the Agency on the supplies they require or can produce, as well as detailed information on quantities, physical and chemical nature, intended use, place of origin, delivery dates, price terms, and so on. The way in which the Agency is to balance supply and demand is spelled out in the 'Rules'.

5.2.3 The Rules

The rules by which ESA is to balance supply against demand when carrying out its role as the guardian of the principle of "equal access to supplies" for all participants on the common market, are determined in the Rules (OJ P 32), according to art. 60 of the Euratom treaty. If the supply and demand of natural gas were to be balanced according to a mechanism modelled on the original procedure spelled out in these rules (the ordinary procedure), the Commission would indeed – as the critics argue – be the one pulling the strings. According to the ordinary procedure, ESA can determine from which producers and at what quantities the individual users are to be supplied, according to considerations for the Union's overall security of supply. In principle however, a simplified procedure for the conclusion of supply contracts is consistently applied during all supply negotiations, as stipulated in art. 5 bis of the Rules (OJ L 193). According to this article, "users shall be authorized to invite tenders directly from the producers of their choice and to negotiate the supply contract freely with the latter" (OJ L 193, art. 5 bis, 1.a). According to art. 5 bis c, 1-7, user shall send the supply contract to ESA for approval within 10 workdays upon signing it, providing information on the following topics;

- the parties involved
- the contracted quantity
- projected delivery dates
- nature of the materials to be supplies
- country of origin of the materials to be supplied
- price and terms of payment
- contractual duration

ESA is then to approve or reject the contract in accordance with its impact on the overall security of supply at the market. Supply contracts with duration of more than 10 years are to be subjected to Commission authorization upon signing (Euratom treaty, art. 60). As the Commission has the right to veto all Agency decisions, one could in theory argue that the Commission can veto whichever supply contract it deems unfit. For the completion of supply contracts related to nuclear materials, there exists – for the sake of simplicity and transparency - a standardized submission form that users are encouraged to make use of when sending in their supply contract drafts to ESA. As such, there exists no secrecy surrounding what requirements ESA is considering. If ESA deems a proposed contract compatible with the provisions and objectives of the Community, it acts as co-signer. If not, ESA either imposes conditions for approval or refuse to conclude the contract. All amendments or any supplementary agreements must also be referred to ESA for signature.

5.3 **An EU Supply Agency for natural gas**

When analyzing the potential of the Polish proposal, I will base my discussion upon the current division of competences between member states and the Commission. According to the consolidated version of the Treaty on the functioning of the European Union, the role of ensuring the functioning of the energy market and the Union's security of supply are shared competences between the Union and the Member states (OJ C 326, art. 4.2.i, and in OJ C 326, art. 194), meaning that "… the Union and the Member States may legislate and adopt legally binding acts in that area [energy]". The competence of the member states, however, shall only be exercised "to the extent that the Union has not exercised its competence". As such, considerations for the functioning of the market and the Union's security of supply are first and foremost a matter of Union policy. However, Union policy in the realm of energy is limited by the exemption provided for in TFEU art. 194.2 regarding the member states'

prerogative to determine the “conditions for exploiting its energy resources, its choice between energy sources and the general structure of its energy supply” (OJ C 326, art. 194.2). A Gas Supply Agency would therefore have quite limited powers compared to ESA. However, as the focus of Tusk is to enable the consistent *rule of law*, a Gas Supply Agency with the task of performing ex-ante compliance controls of supply contracts according to the EU energy acquis might be sufficient for this purpose. The question remains whether or not such rule of law would produce the desired outcomes. In the next chapter, I present Galbraith’s theory on countervailing power in more detail. The analysis follows thereafter.

Chapter 6: Countervailing power

In this chapter I present the logic underpinning Galbraith's claim that it is the countervailing power of those subjected to market power that keeps the growth of private economic power in check, as well as under what conditions countervailing power is likely to succeed.

6.1 American Capitalism – The Concept of Countervailing Power

The concept of countervailing power was first introduced by John K. Galbraith in his book *American Capitalism – The Concept of Countervailing Power* (1952). In its essence, countervailing power refers to market power developing at either side of a market *in reaction* to market power existing at the markets opposite side – the so-called 'original' market power. As market power allows its holder to reap higher gains from trade than what would have been possible on a competitive market, this gain could in theory be reallocated to the benefit of those on the opposite side of the market, if more competitive conditions were established. As such, there exists an incentive for those being subjected to original market power to restore market balance.

The concept of countervailing power was introduced by Galbraith as part of a debate on the limits of competition to inhibit the growth of market power. This debate was sparked by the observation that the American post-war economy, despite being founded upon an unshakeable belief in the virtues of competition, showed signs of increased market concentration. The crux of the belief in the competitive model that underpinned this economy – as well as all modern market economies - is the assumption that competition, due to its alleged self-reinforcing nature, would make the accumulation of market power impossible. The logic is as follows; when competition prevails, no market participant has any influence over the reigning market price – all actors are *price takers*. Thus, all attempts at exercising market power by overpricing or underpaying will result in a complete loss of market share. In the deviant case that someone is able to exercise market power, the associated profits of this market power would induce competitors from the *same* side of the market to try for a share, effectively reinstating competition (Galbraith, 1993, p. 112).This is essentially a circular argument: competition is at the same time dependent on the absence of market power and the 'solution' to market power. The problem with this logic, however, is that competition is regarded as the *only* mechanism keeping market power in check. The

post-war realization that market concentration suddenly had become the norm rather than the occasional and temporary exception thus had people believe that the economy was on the verge of collapse. And, indeed, if we were to follow the logic of the competitive model, the absence of competition *should have* resulted in the unlimited growth of private economic power, and eventually the collapse of the economic system. The American economy, however, prevailed.

Galbraith argued that the explanation for why the economy had not collapsed despite the absence of competition was to be found in the existence of countervailing power. He refers in particular to the labor unions as an example of how countervailing power works to balance out market power. Such unions was established in order to strengthen the power of workers vis-à-vis employers, who, by virtue of their relative scarcity in relation to the abundance of workers, were in position of original market power. And it worked.

The concept of countervailing power is by many deemed controversial (e.g. Stigler (1954)). That the concept is founded upon an assumption about the inherent tendency of capitalist' economies to foster market concentration is particularly so (Galbraith, 1993, pp. 38-40). As we live in an era of profound belief in competition - at least in theory – Galbraith's view is rather unsettling. The entire economic rationale for the EU customs union, the internal market, and now also the common energy market, is that competition will make every one better off. The appeal of the competitive model is that it promises the most effective allocation of labor, capital and goods – and as such, the highest welfare gains. And if we assume that supply and demand according to the given market price is the foundation for all dynamics within a market – as is one of the assumptions underpinning the competitive model – it is a natural conclusion to argue that the model promises

> "…an economic system of high social efficiency... one in which all incentives encourages the employment of men, capital and natural resources in producing most efficiently what people most want" (freely after Galbraith, 1993, p. 12).

Galbraith does not argue that competition is pointless. In fact, he argues that it is of utmost importance at the startup of all industries (Galbraith, 1993, p. 112). His point, however, is that the real restraint to market power is *not* the one provided by the other sellers eager to sell, or the other buyers willing to buy, but rather that ; "…private economic power is held in

check by the countervailing power of those who are subjected to it. The first begets the second" (Galbraith, 1993, p. 111). As such, the tendency towards market concentration that characterizes market economies is not a result of poor competition; "the causes are deeply organic", inherent to the system itself (for an explanation of this, see Galbraith, 1993, p. 33).

6.2 **When does countervailing power succeed?**

6.2.1 Minimum opportunity and organizational capacity, and the requirement of not unlimited demand

Under what conditions do buyers hold enough buyer power to successfully be able to countervail an existing seller power? Galbraith argues that "The development of countervailing power requires a certain minimum opportunity and capacity for organization" (Galbraith, 1993, p. 126). While it is easy to agree with Galbraith in that "it must not be assumed that it is easy for great numbers of individuals to coalesce and organize countervailing power", the EU stands out as a specifically well suited framework for the large scale cooperative organization needed for countervailing power to be possible. Although there is disagreement among academic writers of integration theory as to whether or not integration within the realm of energy – characterized as *high politics* – is possible given the diverging interests of the member states, it is the case that two out of the three founding treaties of the EU-project were adopted in order to establish common energy markets, one of them governed by a single buyer arrangement (The Euratom treaty and the Treaty establishing the Coal and Steel Community) As such, the EU *does* hold the minimum opportunity and organizational capacity to allow for the necessary coordination, disregarding for the purpose of this thesis the fact that member states are likely to guard their energy policy against supranational involvement. Minimum opportunity is also provided by the fact that there are gains to be reaped from improving the governance of the common market for natural gas as this would increase the Union's competitiveness, the Polish proposal being *one* possible strategy to reach this goal.

More important for the purpose of this thesis is a second condition listed by Galbraith; the requirement that the balance between supply and demand be one in which the buyer has the potential to impose costs upon the seller through a change in own market behavior. This

ability depend on the state of aggregated demand; "Broadly speaking, positions of countervailing power have been developed in a context of … not unlimited demand" (Galbraith, 1993, p. 131). Galbraith explains this requirement in the following way:

> "Countervailing power, as a restraint on market power, *only* operated when there is a relative scarcity of demand. Only then is the buyer important to the seller and this is an obvious prerequisite for bringing his power to bear on the market power of the seller. If buyers are plentiful, that is, if supply is small in relations to current demand, the seller is under no compulsion to surrender to the bargaining power of any customer. The countervailing power of the buyer, however great, disappears with an excess of demand" (Galbraith, 1952, p. 136)

Thus, in order to have buyer power, a buyer must have viable outside options to the powerful supplier, so that it can, by switching to an alternative supplier, create a scarcity of demand for the original supplier. What Galbraith refers to when speaking of the impact of the balance between supply and demand on buyer power, is what in newer academic literature on the topic have identified as *relative buyer size* and *supplier competition*. While there is great analytical value in the conceptual framework of Galbraith, there is, however, an "absence of clear empirically established criteria for evaluating countervailing power" (Ruffle, 2005, p. 3). I thus turn to the academic litterature for further insight on the conditions for successful countervailing buyer power. Note, however, that most of this writing is concerned not with the concept of countervailing power per se, but with the mechanisms underpinning successful buyer power. The mechanisms, however, are the same..

6.2.2 Support from the academic literature on why large buyers have more clout

Snyder (1996) once argued that several empirical studies verify the conventional wisdom that "…relative to small buyers, large buyers have an advantage in obtaining price concessions from sellers" (Snyder, 1996, 747). The offered explanations for the occurrence of such large-buyer discounts, however, vary across the academic spectrum. Risk aversion has been presented as one plausible explanation. According to DeGraba (2005), large-buyer discounts are a result of the seller's risk aversion (p. 2). As the possibility of not being able to

'seal the deal' with a larger buyer inhibits a larger risk to the profitability of the seller, the seller is willing to offer the larger buyer a price discount relative to the price offered to smaller buyers. "This lower price reduces the expected profit from the large customer, but increases the probability of making the sale" (DeGraba, 2005, p. 3). As the risks associated with not making a sale increases with the size of the buyer, DeGraba has dubbed this risk-aversion explanation the "pure customer size effect" (DeGraba, 2005, p 1). The effect of an increase in buyer size on the risk assessment of the seller however, is eliminated if the growth of the buyer is caused by a proportional growth in the overall market (DeGraba, 2005, p. 13). As such, it is the *relative* size of a buyer compared to the remaining market, which we assume remain constant, that is of importance. In a similar manner, although based on another mechanism, Snyder (1996; 1998) argues that it is the *intense supplier competition* that arises out of the wish to sell to a large buyer that is the origin of large-buyer discount. According to Ruffle, Snyder's argument is that

> "Large buyers tempt sellers to shade the monopoly price in order to capture the entire demand from themselves. To prevent such out-of-equilibrium deviations, sellers collude on lower prices against large buyers than against smaller ones, yielding the large-buyer-discount result" (Ruffle, 2009, p. 3).

The logic applied by DeGraba and Snyder is essentially two sides of the same story. The underlying mechanism in Snyder's interpretation is that collusion between sellers is hampered in the presence of a large byer, as the size of the potential market makes undercutting and supplying more profitable than what would have been the case with a smaller buyer. The risk of foregoing this undercutting opportunity, potentially allowing it to one of the other suppliers, thus becomes too risky. This claim is supported by Dana (2004) and Inderst and Shaffer (2007). Thus, it is the risk aversion of the seller that creates intense supplier competition, and vice versa. Of course, supplier competition and risk aversion is only applicable to situations in which the buyer faces outside options, in terms of substitutability or alternative suppliers.

Snyder's studies are supported by Ellison and Snyder (2010), although they assign greater importance for buyer power to the ability of a large buyer to substitute among alternative suppliers - meaning that there exists supplier competition – than to sheer buyer-size. While

Chen (2007) argue that "…a useful indicator of buyer power is a buyer's market share, i.e. the buyer's share of purchases in the suppliers' total sales in the relevant upstream market" (p. 18), Ellison and Snyder emphasizes that it is the interaction between buyers size and seller competition that sometimes yields large-buyer discounts. According to these authors, buyers facing a monopoly supplier – that is, a market in which no substitution opportunity/supplier competition exists – will be unable to bear power over the seller's price (Ellison and Snyder, 2010, pp. 35-36). Others (e.g. Chipty and Snyder (1999); Normann, Ruffle and Snyder (2007); Inderst and Wey (2007)) have found that large-buyer discounts *do* occur under monopoly, so long that the joint surplus function for the market is concave in total output (DeGraba, 2005, p. 5). This interpretation, however, is based on a 'matter of fact' assumption about the general way in which market surplus is split between buyers and sellers, and does as such not really relate size to buyer power when understood as *bargaining power* vis-à-vis a strong seller. This perspective will therefore be disregarded in this thesis. Based on Inderst and Wey (2007), however, Le Coq and Paltseva (2012) argue that it is not just the fact that the loss of demand increases proportionally with the growth of the buyers that makes sellers willing to forego some power – it is also the fact that the freed-up capacity becomes increasingly harder and unprofitable to reallocate to the remaining market. According to the authors, the freed-up capacity of a seller that results from a disagreement with a small buyer can rather easily be reallocated by the seller to his remaining buyers, as this capacity is negligible relative to the seller's overall market share (Le Coq and Paltseva, 2012, p. 2). As the size of the buyer increases, however, the seller's remaining market share diminishes proportionally, making the reallocation of any freed-up capacity more difficult (Le Coq and Paltseva, 2012, p. 2). What is more, an influx of a large quantity to the remaining market is likely to create a downward pressure on the price that the seller can charge, thus reducing the seller's profits (Le Coq and Paltseva, 2012, p. 2). It is on this basis that Inderst and Wey (2007) argue that "the supplier's loss from a disagreement increases more than proportionally with the size of the respective buyer" (p. 648). According to this logic, buyer power arises out of the costs that the buyer is able to impose upon the seller. In other words, the bargaining power of the buyer is increased because "an increase in the size of the buyer undermines the seller's outside option, thereby weakening the seller's bargaining position and allowing the buyer to negotiate a preferential treatment" (Le Coq and Paltseva, 2012, p. 2). This logic does, however, imply that the buyer is able to

withholding demand, either by refraining from buyer or by directing this demand elsewhere – and as such, it brings us back to the requirement of outside options.

Two conclusions can draw from the above delineated literature. First, when supplier competition is present, size is the thing that matters in terms of buyer power. It is the size of the buyer that determines the seller's loss of demand should the buyer switch to an alternative supplier, as well as how large the suppliers remaining outside options are (remaining market share when demand from the buyer is no longer present). Second, in the absence of supplier competition – that is, facing a monopolist seller – size does not have an impact on the buyer power of a buyer. Buyers facing a monopoly seller do not have buyer power. The claim of Gunther Oettinger, then Energy Commissioner, that "The greater the monopoly of Gazprom in individual countries, the higher the price it can charge" is completely accurate (Euractiv, 2014)

The emphasis of the academic literature on buyer power on the importance of supplier competition and sufficiently large buyer size support Galbraith's claim that countervailing power only succeeds when the original market power (in this case the seller) faces a market situation characterized by not unlimited demand (or supply, had the original power been the buyer). The source of Gazprom's market power at the EU gas market is the lack of supplier competition in the most import dependent Member States. The reason why the EU so far has been unsuccessful in countervailing Russia's market power is that the Member States are unable to create for Gazprom a scarcity of demand by switching to alternative suppliers. As such, the crucial test of the potential of the Polish Proposal to mitigate Russia's market power is whether or not the coordination of gas purchases as envisaged by Tusk would enable the EU to create for Gazprom a state of not unlimited demand.

With this in mind I now turn to the analysis of the buyer power of the EU under current supply and demand. Will the coordination of gas purchases as proposed by Tusk allow the EU to accumulate enough buyer power to countervail Russia's energy stranglehold?

Chapter 7: Analysis

In the following I will analyze the buyer power of the EU vis-à-vis Gazprom under two buyer structure scenarios: the current uncoordinated buyer structure and an EU single buyer structure (the Polish Proposal). As the EU's buyer power to a large degree depends on the buyer power of the most vulnerable Member States, the focus of my analysis will be what impact the transition from the current uncoordinated buyer structure to the single buyer structure proposal will have on the buyer power of Latvia, Estonia and Finland – here referred to as the Baltic market. While several other of the EU Member States are highly import dependent on Russia (e.g. Slovakia, Bulgaria, the Czech Republic, etc.), the Baltic market is the most extreme example of a buyer without buyer power, being the only group of Member States depending a 100 percent on Russian gas to cover domestic demand. As long as the buyer power of the Baltic market remains absent, Gazprom can continue to use its monopoly power to price discriminate or otherwise impose unfair conditions upon these Member States. They are the Achilles heel of the EU's buyer power so to speak. As such, in order to answer my research question, it suffices to analyze the buyer power of these Member States under the two above mentioned scenarios. As all EU members import gas under long-term supply contract, their expiration is implied when I refer below to a buyer's ability to switch to an alternative supplier.

Chen (2007) argues that, in order to say something about the size and availability of outside options facing various actors within a given market, we must define the market. Specifically, Chen argue that we must limit the market to what outside options are available at low switching costs: "When confronted by a retailer demanding lower than normal prices, a supplier may want to sell its product to an alternative retailer. This option, however, may not be a profitable one if it faces significant costs, in which case, the alternative retailer has to be excluded from the relevant upstream market" (Chen, 2007, pp. 29-30). As the costs associated with constructing a new pipeline qualifies as a high switching cost, I will limit my analysis to the current import/export market facing the EU and Russia in terms of existing infrastructure. For the sake of illustrating the importance of outside options for buyer power, however, an exemption will be made in my discussion on the current buyer power of the Baltic market, in which I include a short reflection on what impact the realization of the

recent Finnish-Estonian deal to establish two LNG terminals would have on the buyer power of these Member States.

As mentioned earlier, the EU imports both dry and liquefied natural gas from several extra-EU producers. Given the current supply infrastructure, most of the Member States have some degree of outside options to Russian gas. The figure below illustrates existing export pipelines to the EU market, as well as their relative capacity. Note here that alternative suppliers to Russia do not have enough capacity to replace the quantities of gas currently supplied by Russia.

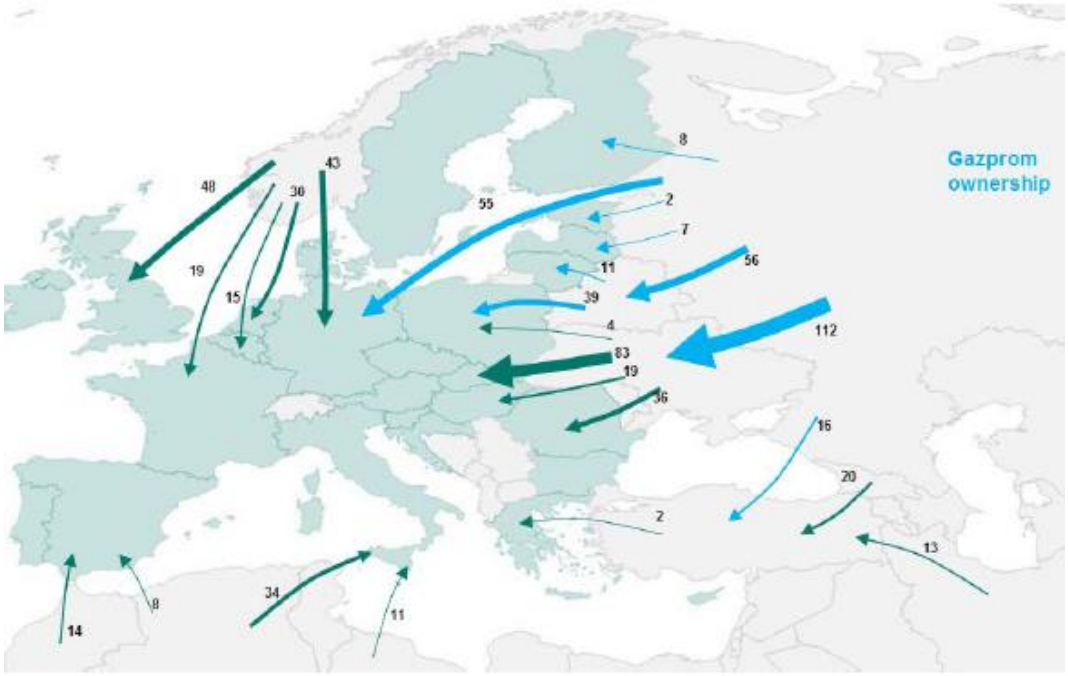


Figure 10: Current pipeline infrastructure to supply the EU, bmc/annually. Source: Holz et al, 2014, p. 25.

Gazprom only export market for dry gas is the European continent, and the only outside options to the EU market available to the company is Turkey (16.5 percent) and some non-EU Eastern European states (8.8 percent) (Gazprom, 2015a). As such, there exist a mutual dependency between the EU and Russia.

7.1 **EU buyer power under two buyer structure scenarios**

7.1.1 ***Scenario one****: EU buyer power under the current uncoordinated buyer structure*

Under the current buyer structure, purchases of gas from extra-EU suppliers are wholly uncoordinated. Supply contracts are subjected to compliance control vis-à-vis the energy acquis only after their ratification, and as such, it is rather easy for Gazprom to abuse its seller power. Under this scenario there is a clear concurrence between the outside options and relative size of buyers and their degree of buyer power vis-à-vis Gazprom, as predicted by Galbraith and the academic literature referred to in this thesis. Germany, Italy and France serve as good examples of Member States with buyer power, as all faces several outside options to Gazprom. About 50 percent of Germany's import demand is covered by gas from Norway and the Netherlands, and some 13 percent is purchased as non-contracted hub gas (IEA, 2014). As such, by virtue of being connected to alternative suppliers, Germany faces low switching costs and can credibly threaten to substitute away from Russian gas when current supply contracts expire. The same holds true for Italy and France. Italy gets the bulk of its import demand covered by Algerian dry gas and LNG (32 percent), as well as gas from the Netherlands, Libya and Qatar (IEA, 2014). The French demand is covered mostly by gas from Norway (42 percent) and the Netherlands (19 percent), as well from Algeria, Nigeria and non-contracted hub gas (IEA, 2014). The buyer power that these Member States hold vis-à-vis Gazprom by virtue of having credible outside options is enhanced by the fact that they are all important exports markets for Russian gas, together accounting for nearly 52 % of Gazprom's total EU demand (Gazprom, 2015a). If we are to follow that logic applied by Le Coq and Paltseva, as referred to in section 6.2.2, the large market share held by these countries is a source of buyer power because it would be difficult for Russia to reallocate the freed up capacity that would result should these Member States switch to other supplies, without suppressing the prices at the company's remaining export market. Thus, by virtue of supplier competition and relative size, all three Member States would be able to reduce their demand for Russian gas if Gazprom were to impose higher prices or otherwise less favorable terms in a new supply contract - and in this way create a scarcity of demand; according to Galbraith the most important prerequisite for countervailing power. As Russia faces less favorable outside options than what does Germany, Italy and France due to the above mentioned downward pressure on prices, not reaching a supply deal with these

Member States would likely be relatively more costly for Russia. Much due to their importance as export markets – but also due to their role in setting the EU agenda – all three countries are for Russia what Leonard and Popescu refers to as *strategic partners*, meaning that they "enjoy a 'special relationship' with Russia", which occasionally has been pursued to the detriment of common EU policies (Leonard and Popescu, 2007, p. 2). An example is the Russo-German construction of the Nord Stream pipeline, which was opposed by many because this direct export route to Western Europe would allow Russia to circumvent the Eastern European market, and as such increase Russia's ability to use gas politics in this market without it impacting exports to Western Europe (Pop, 2010). Some even went as far as dubbing the deal a second Molotov-Ribbentrop Pact (e.g. Euractiv (2010); Petersen(2009)). For Germany, Western Europe and Russia however, it provides a direct link between supply and demand, circumventing both Belarus and Ukraine.

That the above mentioned Member States have buyer power under the current EU buyer structure is supported by the fact that they were all able to renegotiate the price terms of their long-term contracts with Gazprom in 2011/2012 to a price more closely aligned with the one prevailing at the hubs (renegotiations were concluded for GDF SUEZ (France), Wingas GmbH (Germany) and Sinergie Italiane (Italy) (Gazprom, 2012). Renegotiations were also admitted to the Italian company ENI in 2014, involving "reduction in supply prices and an important change in the price indexation to fully align it with the market" (ENI, 2014). The alignment of the contracted price with that on the hubs is a major concession by Russia, who have always insisted on the continued use of oil-indexation (Gazprom, 2015).The background for these renegotiations was the drop in hub prices that resulted from the reduced demand in the aftermath of the financial crisis, as well as the influx of non-contracted Qatari LNG – originally destined to the US market, but diverted as the demand decreased due to the so-called shale gas revolution. These two developments created a 'buyers' market' for gas due to the high supply relative to demand (Franza, 2014, p. 12). The renegotiations illustrate the importance of supplier competition on buyer power. In order to maintain market share, Gazprom had to concede to the requirements of the buyers.

Germany, France and Italy represent examples of the most powerful EU buyers and as such stand in stark contrast to that of the Baltic market. Within this market, Gazprom has an absolute monopoly position as supplier. As no indigenous production is present in the Baltic

market, it rely a 100 percent on imports to cover demand – all of which is provided by Russia. The fact that these countries are isolated from the larger EU gas grid and have no LNG terminals enhances their vulnerable position (see figure 11).

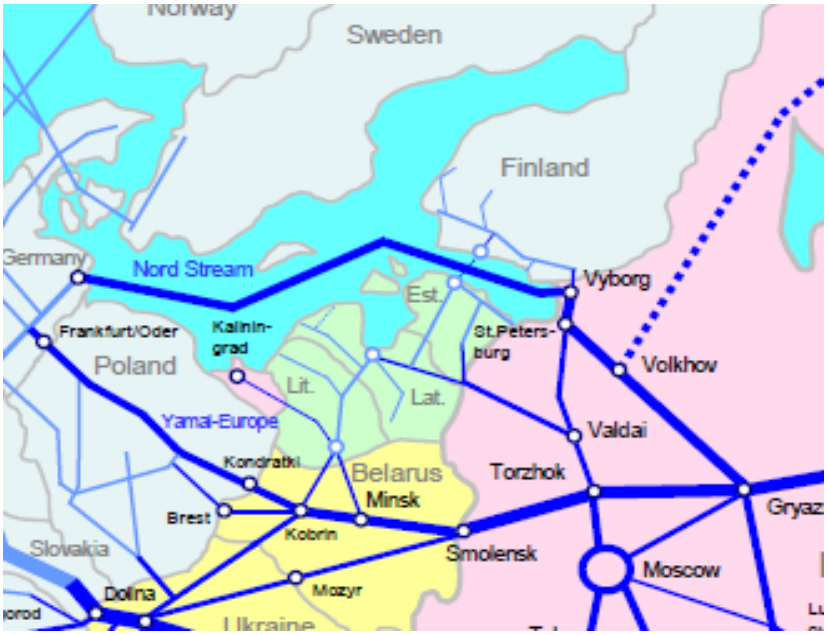


Figure 11: Baltic pipelines. Source: Eastern European Gas Analysis, 2014

Given that the Baltic market is faced with a monopoly supplier, they have no buyer power. Finland and Estonia have, however, agreed upon the building of two LNG terminals, one in each country, as well as the construction of a pipeline to connect the two markets – the so-called Balticconnector pipeline (Molin, 2014). If this plan is realized, the buyer power of Finland and Estonia vis-à-vis Gazprom would increase significantly. However, as Gazprom is shareholder in the transmission and distribution networks of all the Baltic States', the realization of this project depends on the full implementation of the third energy package so as to ensure non-discriminatory third party access to the network for the liquefied gas imports. When Lithuania implemented the principles of unbundling and third party access to enable the transmission and distribution of LNG imports, Gazprom sued the Lithuanian government on the grounds that the implementation of the third energy package violated the privatization of Lietuvos Dujos, the largest Lithuanian gas company, of which Gazprom held a 37.1 percent ownership (Rapsi, 2015). As Gazprom is unable to act as both supplier and operator of the transmission and distribution network under the third energy package,

the Lithuanian implementation effectively expropriated Gazprom (Natural gas Europe, 2015).

Thus, in the same way as it is the supplier competition facing Germany, Italy and France that is their source of buyer power, it is the lack of outside options that is the crux of the non-existent buyer power of the Baltic market. The importance of outside options for buyer power was recently illustrated in Lithuania, which up until last winter was - like the rest of the Baltic States - an energy island. Lithuania is completely dependent on imports to cover demand, and Russia has traditionally been the country's only supplier. Last year a Lithuanian LNG terminal – appropriately named *Independence* - became operational, allowing Lithuania to import LNG from Norway. This development, which effectively ended Gazprom's monopoly at the Lithuanian market, allowed Lithuania to renegotiate its Russian supply contracts, the result being a 20 percent price reduction (Czerwiec, 2014). While Independence has enough capacity to supply Estonia and Latvia in addition to Lithuania, the former two are currently tied to long-term supply contracts with Gazprom and are such unable to reap the benefits that an additional supplier could have brought to their buyer power.

*7.1.2 **Scenario two**: EU buyer power under a single buyer structure (the Polish Proposal)*

The rationale underpinning the idea of coordinating all gas purchases under a Commission supervised and mandatory EU wide Gas Purchasing Agency (GPA) – as proposed by Tusk – is that it would allow the EU to buy natural gas as a single buyer, supported by the combined buyer power of all the EU Member States. As Hubert and Orlova (2012) argue, "With respect to the outside world, political centralization yields the same result as if the national champions would merge into a single 'European super champion'" (p. 17). The crux of the single buyer scenario is that all new supply contracts would be drafted according to a template contract– as is the procedure under ESA – and thereafter subjected to a uniform ex-ante compliance control. This coordination would allow the Union to project a truly common external energy policy, and as such, the EU would trade as a block, making it the world's largest buyer of gas. If we are to follow the logic of Snyder, the EU would attract intense supplier competition when trading as a block, as the large scale supply contracts made possible under a single buyer scenario are lucrative for sellers because such contracts

provide them with enhanced security of demand and export revenues. We can thus expect higher degrees of supplier competition under the single buyer scenario than under the current scenario, and in an extension of this, lower prices due to price competition between the suppliers. Or at least so the story goes. While Tusk justified his proposal on the grounds that an Energy Union would restore competition thorough price harmonization (2014a), this is not necessarily the case. In response to the Polish proposal, Alexei Miller, head of Gazprom, warned the EU members who currently enjoy a relatively lower price on Russian gas imports to pursue the Energy Union project, as this would result in them paying higher prices. As part of this warning, Miller made the rather revealing claim that "A common price isn't the lowest price. It will most obviously be the highest price" (The Economist, 2015). Since purchasing gas as a single buyer does not mitigate the problem of poor interconnection between the most vulnerable Member States and the overall EU gas market, Russia could still charge higher prices to those that have no outside options. If the EU is to trade as a block, Russia could impose this high price on *all* member states, and allow that those with outside options switch to other producers as a result. Since alternative producers do not have enough capacity to replace all Russian export to the EU, the outside options are rather limited when looking at the EU as a whole. Russia is aware of this. As Russian president Medvedev has argued, "I think that logic of European business cooperation won't allow dementia to set in. Russian export restrictions are impossible" (Russian Times, 2014). As such, Miller does have a point. Others however, argue that the threat has no foundation in the reality of the situation. As argued in an article published by The Economist;

> "If Mr Miller imagines he could convince an all-European authority to pay as much as the highest price paid by any single European country, he may be inhaling too much of his company's fumes" (2015)

Although the above cited argument seems rather intuitive, we must remember that the EU might not have any other choice than to pay the price offered by Russia.

While an EU single buyer could result in increased price competition, it could also result in the opposite. Countervailing power works both ways, and suppliers might be induced to price collude. A scenario in which Norway joins a price collusion scheme with Russia is,

however, highly unlikely, and Algeria currently faces competition from the global LNG market and would thus loose out should it increase the prices beyond the competitive level. Russia and Algeria could, however, due to their importance as dry gas exporters to the EU (45 percent share of total EU gas import), potentially create a dry gas cartel together with Central Asian and Middle Eastern producers, as they have been deliberating for some while (Kupchinsky, 2006) . For now at least, they are competitors, and as such, do not price collude. Regardless, the logic applied by Tusk is that, in order for Gazprom to maintain its market share at the EU market under the single buyer scenario, the company would have to follow suit with the price development, as alternative gas suppliers would otherwise become more attractive for the EU, which in turn would lead to a substitution away from Russian gas and a scarcity of demand for Gazprom. This logic is flawed due to the above mentioned limit on the capacity of alternative suppliers, and it will only apply so long as there is only a few companies that threatens with switching suppliers. In the Western European gas market, some companies have successfully been able to renegotiate their supply contracts. Faced with competition from relatively lower prices on non-contracted hub gas, both Norway and Russia have been willing to renegotiate the price terms of their long-term supply contracts so as to ensure that more than the minimum contracted quantities under the take-or-pay agreements are actually taken rather than being substituted with relatively cheaper gas from other suppliers. Had they not been willing to do so, the buyers would have had the option to take the minimum quantity only, and buy the rest form the hubs. Unwillingness of the supplier to renegotiate could also have induced the buyers to, upon the expiry of the current contracts, discontinue the trade-relationship. When the Italian company ENI was denied its request for a price renegotiation of its long-term contract with the Algerian company Sonatrach, the result was instead a renegotiation of the take-or-pay clause, significantly reducing the contracted volumes, to the detriment of the Algerian company (Reuters, 2013). The mechanism described here, however, would not have had the same impact had *all* of the European companies with outside options threatened to substitute away from Russian gas – there would simply not have been enough gas to cover their demand.

The idea that the EU is able to act as a single buyer is also somewhat flawed. While supranational coordination of gas purchases would certainly allow the EU to act as a *de jure* single buyer, it would not result in the EU trading as a *de facto* single buyer. The reason is

simple; the Baltic market would still only be able to import gas from Russia, and the single buyer scenario does therefore not mitigate the problem of Russia's market power. As these Member States cannot 'go without', the Gas Supply Agency cannot readily refuse to co-sign supply contracts for this market on the ground that the contracts are in violation of the energy acquis. Thus, no scarcity of demand can be created for Gazprom in the Baltic market. While the enhanced supplier competition under the single buyer scenario would increase the buyer power of the Member States that are interconnected and already faces several suppliers, it would not have an impact on the buyer power of the Baltic market per se. While it could be argued that some of the powerful buyers at the larger EU market could threaten to switch to alternative suppliers should Gazprom misbehave in the Baltic market, it could just as easily be argued that Gazprom would retaliate on this loss of market share by increasing the prices to this market even further. It can also be argued that Gazprom in general could be induced to 'make up' for the loss of revenue that would result from the relatively lower prices at the larger EU market due to supplier competition by increasing its prices on the Baltic market. The allegations of price discrimination and other abuse of market power currently facing Gazprom has thus far not prompted a reaction from the EU buyers that do have buyer power under the present buyer structure – e.g. Germany and Italy-, and it is uncertain whether or not a single buyer scenario would yield a different reaction.

The question thus remains whether or not a single buyer arrangement would be sufficient to mitigate Russia's *willingness* to abuse its monopoly power. As Russia already regards the EU liberalization process as a political witch-hunt aimed solely at Gazprom's monopoly, it is unlikely that the establishment of an EU wide purchasing block will create better political relations.

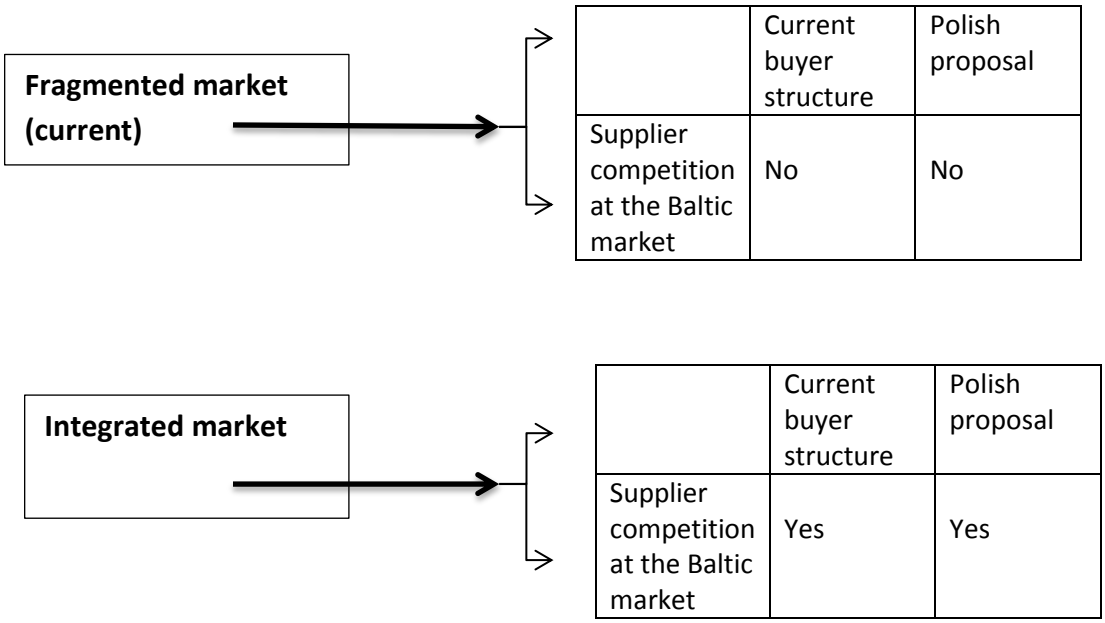
To sum up; while the buyer power of the already powerful EU buyers would be somewhat enhanced under the single buyer scenario proposed by Tusk, as they would be faced with more supplier competition and possibly lower prices, the monopoly power of Russia would prevail at the Baltic market due to it being isolated from the EU gas grid. The EU would therefore be unable to threaten with a scarcity of demand in the parts of the market where such action is needed, and the single buyer scenario would therefore not allow the EU to countervail Russia's market power where it is most present. Due to the limited capacity of

alternative suppliers, only Member States with outside options can substitute away from parts of the current Russian gas imports. In the long run – given that current levels of demand are sustained – they might need to return to Russian gas, as Russia holds the world's largest reserves. The countervailing power potential of the single buyer scenario depends to a large degree on the risk aversion of Gazprom; will it comply not to lose market share in the overall EU market, or will it retaliate by increasing its current monopoly prices? It is therefore not possible to conclude with certainty on the effectiveness of the Polish proposal to mitigate Russia's market power, although the above analysis indicates that it will not succeed.

7.2 **Main findings and comments**

Given the requirement of outside options/supplier competition for the success of countervailing power, I have found that the realization of the Polish proposal will not allow the EU to mitigate Russian market power in terms of facilitating buyer power for the Baltic market. What regards the effect on the buyer power of the Union as a whole, the results are less unequivocal. Had all Member States been properly connected to the EU gas grid so that gas could flow freely between all suppliers and national markets, the single buyer scenario would likely enhance the buyer power of both the Baltic market and the EU at large. As the countervailing potential of the single buyer scenario rests upon the willingness of the Member States with buyer power to retaliate Gazprom's abusive market behavior in the Baltic market by substituting Russian gas with alternative gas supplies – an option that is limited by the insufficient capacity of alternative producers - as well as Russia's risk-aversion, it is impossible to conclude with certainty what impact the pooling of buyer power at a supranational level would have on Russia's market power. Given that Gazprom has a reputation for not complying with the EU energy acquis – which we must not forget is already present despite compliance controls only being possible *after* supply contracts become operative – as well as the unwillingness of the current powerful buyers to retaliate against Russian market abuse, the most appropriate conclusion is that a single buyer scenario under the current levels of interconnectedness would not allow the EU to countervail Russia's market power – neither directly or indirectly.

If we compare these results with the levels of buyer power that would have been possible under the current buyer structure and the single buyer structure in a fully integrated market, we see that it is not the buyer structure that is the problem, but rather the levels of interconnectedness (see figure 12)



	Current buyer structure	Polish proposal
Supplier competition at the Baltic market	No	No

	Current buyer structure	Polish proposal
Supplier competition at the Baltic market	Yes	Yes

Figure 12: Comparison of buyer power in a fragmented vs. an integrated EU gas market under two buyer structures.

Had the market been fully integrated so that supplier competition was possible at the Baltic market, the buyer power of this market would have been increased even under the current buyer structure. As such, it would be wiser for the EU to focus on a strategy for completing the common gas market in terms of interconnection rather than on a strategy for the coordination of gas purchases. Development of infrastructure is, however, devoted a separate 'pillar' in the Polish proposal, a fact which is not included in this thesis. The idea of coordinating all gas purchases under a single supranational regulatory body should nonetheless not be discarded. If the EU is able to improve the levels of interconnectedness between the Member States, a single buyer scenario would definitely yield enhanced 'buyer power clout' compared to the current situation. More importantly, it would allow the EU

improved oversight of the market situation at all times, which would make it easier to formulate new strategies for how best to cope with issues of security of supply. For now, emancipation from Russian gas seems impossible so long as the current gas demand is sustained. This realization – which many has overlooked- might give new political impetus to exploring the possibilities that lies within renewable energy.

Chapter 8: Conclusion

The research question of this thesis is whether or not *the establishment of an EU single gas buyer will allow the EU to countervail Russia's market power* on the EU gas market. I have analyzed this question according to the Polish proposal, in which Tusk spells out how such a single buyer arrangement should be organized. My analysis have been guided by the conceptual framework of countervailing power provided by Galbraith, as well as recent academic literature on buyer power. I have focused on what effect a transition from the current uncoordinated buyer structure to the single buyer structure would have on the buyer power of the Baltic market (Lativa, Estonia and Finland). This choice is justified on the grounds that the Baltic market have the least buyer power vis-à-vis Gazprom of all the EU Member States, and as such represent the Achilles heel of the EU's overall buyer power vis-à-vis the company; if the buyer power of this market is not enhanced under the single buyer structure, the EU will not be able to countervail Russia's market power in the areas of the EU market where it is most needed.

I have analyzed the potential of the Polish proposal to enable the EU to countervail Russia's market power according to the two conditions for effective countervailing power identified by Galbraith. I have argued that the EU holds both the minimum opportunity for, and organizational capability to coordinate all Member States behind a common position vis-à-vis Gazprom – the first condition for effective countervailing power - as such coordination has been achieved before (Euratom; The single market). The second condition identified by Galbraith, that the buyer wishing to countervail the power of a seller must be able to create a state of not unlimited demand for said seller, has been analyzed in detail under both the current buyer structure and the single buyer structure. I have argued that, according to the literature on buyer power, the ability of a buyer to create a state of not unlimited demand depends on what outside options exists for the buyer in the relevant market, and as such found that a prerequisite for countervailing power is *supplier competition.* When supplier competition is present, relative *buyer size* enhances the effects of countervailing power as a larger buyer naturally can threaten to withhold (direct towards another supplier) a relatively higher demand than what can a smaller buyer.

I have found that the requirement of supplier competition is unfulfilled for the Baltic market under both scenarios. What regards the EU single buyer scenario I have argued that, although the buyer power of the already powerful and well diversified Member States would increase, such a buyer structure will not increase the buyer power of the Baltic market per se. It is uncertain whether or not the increase in buyer power of the already powerful and diversified Member States – which most likely will create a pressure on Russia to comply with the energy acquis on a regional basis – will induce Russia to end its energy stranglehold over the Member States in which it still has monopoly supplier power. What is more, as alternative suppliers do not have enough capacity to replace the totality of Russian gas imports to the larger EU market, the outside options of the EU is limited. The Union will therefore be unable to create a large enough scarcity of demand to *force* Russia to comply, and it is very likely that Russia will react on efforts to substitute away from Russian gas by increasing the prices for those that have no outside option. If we expand the scope of this thesis to also include the threat of supply cut-offs, it is obvious that Russia has the upper hand regardless of how the EU structures its gas purchases. We must also take into consideration that Russia holds the world's largest reserves of natural gas. It is therefore impossible for the EU to emancipate itself from Russian gas so long as the current level of demand is sustained, both in the present and in the long term.

An observation arising out of my analysis is the fact that it is not the lack of coordination of supply contracts that is the main barrier to EU buyer power, but rather the lack of interconnection. Subjecting supply contract with extra-EU producers to an ex-ante Commission supervised compliance control with the energy acquis – the crux of the Polish proposal – would nonetheless serve to enhance the functioning of the EU energy market through improved market monitoring and law abidance (albeit not necessarily by Russia). What is more, the realization of the Polish proposal would create for the EU a much needed common external energy policy, effectively enabling the Union to speak with one voice abroad.

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